



LUND UNIVERSITY
School of Economics and Management

BUSN69

VT 2012

Could mandatory audit firm rotation
improve audit quality?

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Abstract

Title: Could mandatory audit firm rotation improve audit quality?

Seminar date: 2012-05-31

Course: BUSN69, Degree Project in Accounting and Auditing, 15 University Credit Points (15 ECTS).

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Five key words: Mandatory audit firm rotation, auditor independence, auditor, Green Paper, regulations.

Purpose: This thesis examines the opinion of stakeholders concerning mandatory audit firm rotation and their perceived advantages and disadvantages. Our aim is to investigate if the rule could affect audit quality and in order to best answer our research questions, we have used a triangulation method, which means that this thesis uses three types of studies of audit firm rotation: interviews, investigating the comments on the Green Paper and publicly available articles published by academics and professional bodies. We are also interested of how the debate of mandatory audit firm rotation and auditor independence has developed regarding the European Commission's Green Paper and how the United States, Sweden and Italy has adapted to the rule in order to protect auditor independence.

Methodology: We have chosen to conduct a study on mandatory audit firm rotation and auditor independence and make use of a qualitative research. We mainly used primary data, in the form of interviews, in the empirical section, and secondary data, in the theory section, in the global context, in the literature review and in the chapter about the European Commission and its comments.

Theoretical perspectives: This section will mainly show the theories of the auditor, the stakeholders' model, auditor independence and its threats and safeguards.

Empirical foundation: Our empirical study consists of six interviews from four certified public accountants and two investors from financial institutions, also called primary data. We have also used documentary sources regarding the comments on the Green Paper.

Conclusions: By analyzing the theory, our chosen articles, comments on the Green Paper and our interviews, we can conclude that mandatory audit firm rotation is perceived as an unnecessary procedure without any actual evidence of fulfillment of the intended purposes. The debate occurs between audit firms, academics, regulators and companies with the main focus on the perceived advantages and disadvantages of mandatory audit firm rotation, such as additional costs, audit quality, auditor independence and loss of knowledge. Based on our three studies, we can conclude that there is no support for mandatory audit firm rotation since the disadvantages outweigh the benefit, and does therefore not improve audit quality.

Abbreviations and definitions

AICPA = The American Institute of Certified Public Accountants

Association for Authorized Auditors = Föreningen Auktoriserade Revisorer, FAR

Auditors Act = Revisorslagen, RL

Companies Act = Aktieföretagslagen, ABL

Confederation of Swedish enterprise = Svenskt Näringsliv

FEE = Fédération des Experts Comptables Européens

GAO = The General Accounting Office

ICAEW = The Institute of Chartered Accountants of England and Wales

PCAOB = The Public Company Accounting Oversight Board

PIE = Public-interest entity

SEC = Securities and Exchange Commission

SOX = Sarbanes-Oxley Act in 2002

Supervisory Board of Public Accountants = Revisorsnämnden, RN

Swedish Audit Community = Svenska Revisorsamfundet, SRS

Supervisory Board of Audit = Revisorsnämnden, RN

Green Paper = first draft document that handles a specific topic. This paper circulated among interested parties who are invited to a process of consultation and debate. The objective of a Green Paper is to arrive at a general consensus before drafting the final official policy document (BusinessDictionary, Green Paper).

Regulation = the most direct form of EU-law. When passed, they have a binding legal force in every member state, on a par with national laws. The national government does not have to take action themselves to implement EU regulations. The EU Council, the EU Parliament and the Commission pass regulations jointly (EU Commission, What are EU regulations).

Directives = an EU directive lay down a certain end result that must be achieved in every member state. National authorities are free to decide how to adapt their law to meet these goals. A directive comes with a date, which by the national laws must be adapted. This gives the national authorities some room for maneuver within the deadline (EU Commission, What are EU directives).

Acknowledgement

We would like to thank everyone that has been involved in the development of our thesis and those who have helped and contributed to the completion of this thesis.

First of all, we would like to thank our supervisor, Anne Loft, who has accompanied us the whole period. Thank you for your valuable feedback, knowledge and discussions during that time. The interaction helped us to head towards the right direction and improved the overall quality of the research.

We would like to give extra big thanks to all respondents that we have interviewed and who have helped us with our thesis. This thesis could not be completed without all your help and the knowledge you have offered, and we appreciate the time you have spared to participate in our thesis.

Thank you!

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May 2012

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Table of Contents

- Table of Contents..... 6
- 1. Introduction..... 1
 - 1.1 Background..... 1
 - 1.2 Problem discussion and research questions.....2
 - 1.3 The aim of the thesis3
 - 1.4 Delimitations3
 - 1.5 Disposition.....4
- 2. Methodology 6
 - 2.1 Research approach6
 - 2.1.1. Interpretivistic approach6
 - 2.1.2. Inductive strategy7
 - 2.1.3. Qualitative research8
 - 2.2 The collection of data9
 - 2.2.1 The primary data9
 - 2.2.1.1 The selection of respondents9
 - 2.2.1.2 Semi-structured interviews10
 - 2.2.1.4 Approaches and follow-ups11
 - 2.2.2 Secondary data12
 - 2.3 The quality of the study.....13
 - 2.3.1 Reliability14
 - 2.3.2 Validity.....15
 - 2.3.3 Criticism of the sources16
- 3. Theory..... 17
 - 3.1 The role of the auditor17
 - 3.1.1 The Stakeholder model18
 - 3.2 Auditor independence.....19
 - 3.3 Threats to independence.....20
 - 3.4 Safeguards22
 - 3.5 Table of the chosen theories24
- 4. The global context 25
 - 4.1 The United States’ protection of auditors’ independence25
 - 4.1.1 Enron and the following legislation of SOX26

4.2 Mandatory audit firm rotation in Sweden.....	29
4.2.1 National bodies in Sweden	29
4.2.2 Sweden’s protection of auditors’ independence.....	30
4.2.3 The new proposal in Sweden.....	33
4.3 Italy and the Parmalat-scandal	34
4.4 Table of the global context	35
5. Literature review	36
5.1 The chosen articles and their reliability	36
5.2 Academic articles for and against mandatory audit firm rotation	38
5.2.1 "Mandatory audit firm rotation in Spain: a policy that was never applied" (2007).....	38
5.2.2 "The Audit Firm Rotation Rule: A Review of the Literature" (2005)	39
5.2.3 "Audit firm tenure and fraudulent financial reporting" (2004).....	41
5.3 Professional bodies’ articles for and against mandatory audit firm rotation.....	42
5.3.1 "Mandatory Rotation of Audit Firms" (2002).....	42
5.3.2 "Mandatory Rotation of Audit Firms" (2004).....	43
5.3.3 "Public Accounting Firms – Required Study on the Potential Effect of Mandatory Audit Firm Rotation" (2003).....	44
5.4 Table of academic and professional articles.....	46
5.4.1 Table 1: The academic articles.....	46
5.4.2 Table 2: The professional articles	48
6. The European Commission and mandatory audit firm rotation	50
6.1 Green Paper Audit policy: Lessons from the Crisis.....	50
6.2 Summary of the response on the Green Paper regarding mandatory audit firm rotation	51
6.2.1 Professional bodies, the big four, Mid Tier Firms and SMPs.....	51
6.2.2 Investors, Public Authorities and Academics.....	51
6.3 The presentation and selection of the various comments.....	52
6.3.1 Four different professional bodies and organizations in Sweden and their comments.....	53
6.3.2 One Italian organization and their comment	54
6.3.3 Five different professional bodies and organizations in the UK and their comments	55
6.3.4 The big four Audit Firms.....	57
6.3.5 Other audit firms.....	58
6.3.6 The United States.....	60
6.4 The final proposal for regulation	60
6.5 Table of the opinions from our selected comments.....	62

7. Empirical study	64
7.1 Interviews with four audit firms	64
7.1.1 How does your audit firm prepare for, and discuss, the EU proposal about mandatory audit firm rotation?	64
7.1.2 Do you think the rule would affect auditors' independence?	65
7.1.3 Which advantages do you consider that mandatory audit firm rotation has?	65
7.1.4 Which are the disadvantages with mandatory audit firm rotation?	66
7.1.5 Do you think that the rule would increase or decrease audit failures?	68
7.1.6 Do you think that various threats, for example the familiarity threat, against auditor independence would be reduced or enhanced by the rule?	69
7.1.7 How do you believe the rule would affect your audit firm and your clients?	70
7.1.8 What is your suggestion to increase auditors' independence?	70
7.2 Interviews with two investors in the financial institutions	71
7.2.1 How do you use the financial statements and of what importance are they to your work?	71
7.2.2 Is your industry aware of the problem with auditor independence and the effect it could have on audit quality? Have you heard about the EU proposal about audit firm rotation?	72
7.2.3 How does financial institutions deal with audit problems and do you think that an audit firm rotation would affect audit quality?	73
7.2.4 Have you ever doubted the audit quality in the annual reports that you have worked with and how did this affect your decision?	73
7.2.5 As a user of the annual reports, would you have a higher confidence in the reports if the audit firm rotation had been mandatory? Would the credibility be higher?	74
7.2.6 Do you think that the rule could prevent future financial crisis and corporate scandals?	74
7.2.7 What suggestions do you as a user of the annual reports have to increase auditor independence?	75
8. Analysis	76
8.1 Analysis	76
8.2 The auditors' independence	76
8.3 Audit quality, familiarity threat and the loss of knowledge	81
8.4 New fresh look	85
8.5 The associated costs	86
8.6 Audit failures	87
8.7 The overall opinion and alternatives	88
9. Conclusions	91
9.1 Conclusions to our research questions	91

9.1.1 How is the mandatory audit firm rotation proposal perceived by the audit profession and financial institutions?	91
9.1.2 How have the United States, Sweden and Italy protected auditor independence and how have they adapted to mandatory audit firm rotation?	91
9.1.3 How is the debate about mandatory audit firm rotation proceeding amongst academics, financial institutions, audit firms, public authorities, organizations and professional bodies after the EU Green Paper was published in 2010?	93
9.1.4 What advantages and disadvantages are perceived for mandatory audit firm rotation?.....	94
9.1.5 Could mandatory audit firm rotation improve audit quality?	95
9.2 Proposals for further research.....	95
Literature list	96
Appendix 1.....	103

1. Introduction

1.1 Background

In a free market, credible financial information is a necessity for companies. One important way for securing credibility in the chain of financial reporting is through statutory auditing. High quality auditing requires that the auditor is objective and competent. However, in the last decade there have been some major corporate scandals, such as Enron in the United States and Parmalat in Italy (Porter, Simon and Hatherly, 2008, p. 65 and 102). In the search for people that could be held responsible, the auditors' role is always mentioned. Politicians, media and academics are quick to blame the audit profession for not doing their job as the society could expect. After the global financial crises in 2008-2009, where some large banks were forced to file for bankruptcy, the debate once again bloomed up. Now there was no doubt that auditors was, to some extent, accountable for the crisis, because no one had pointed out that banks assets balance sheet was full with complicated assets. This raised a lot of question from the public and by politicians. As a consequence of this, the European Union thought that it was time to act and auditor independence was lifted up on the agenda. The result was that the EU commission on the 13th of October 2010, through the commissioner Michael Barnier, published a Green Paper with the intention to create a stronger financial market within the EU. Another purpose with the Green Paper was to increase auditor independence, which Mr Barnier meant was so weak it needed to be strengthened by regulation. It was therefore a suggestion in the Green Paper that there should exist a legal requirement for mandatory audit firm rotation for companies with public interests. (Green Paper Audit policy: Lesson from the Crisis, 2010).

The idea with mandatory audit firm rotation is not new. Professionals and regulatory bodies have discussed this subject since Senator Metcalf in 1976 suggested auditor rotation as a safeguard to prevent auditors to become too familiar with its clients. Mandatory audit firm rotation is an extension of audit partner rotation, but instead of just a partner rotation, the whole audit firm is being replaced after a fixed number of years. The replaced audit firm is then not allowed to take on the old client until a fixed period of years has elapsed. Some countries had tried mandatory audit firm rotation through the last two decades but they have later abandoned the idea (Porter, Simon and Hatherly, 2008, p. 137).

The debate about mandatory audit firm rotation was once again on the agenda after the Green Paper was published and there were many stakeholders that wanted to make their opinion heard, such as professional bodies, audit firms, financial institutions, regulators, companies and academics. All these stakeholders contributed to the debate and their presented argumentation was mainly built on the benefits and consequences with mandatory audit firm rotation. After the closing of the consultation period on the 8th of December 2010, over 700 responses had been received (Summery of responses Green Paper Audit policy: Lessons from the crisis). The reason to the large number of responses is that the Green Paper raised a debate since it proposed a lot of changes for the audit industry. The final proposal on specific requirements regarding statutory audit of public interest entities was published on the 30th of November 2011. In the proposal, a mandatory audit firm rotation will take place after a maximum period of six years and this can, under exceptional circumstances, be extended to eight years.

1.2 Problem discussion and research questions

After the occurrence of a financial crisis or corporate scandal, mandatory audit firm rotation is often suggested as one way to increase auditor independence, since it is important for stakeholders to be able to rely on the audited financial statements. Independence is therefore seen as an important way for ensuring that the work performed by the auditor is credible (Porter, Simon and Hatherly, 2008, p. 65). But mandatory audit firm rotation is a subject that creates an intense debate among different stakeholders. After the financial crises in 2008-2009 the EU commission, through the commissioner for internal markets and services Michael Barriner, released a Green Paper where audit firm rotation once again was suggested. Since mandatory audit firm rotation is a hot topic for many stakeholders, it is interesting to see how the debate is proceeding and what argument both sides are using to prove their reasoning. How do the academics, professional bodies, audit firms and investors think about mandatory audit firm rotation? Should it be used as a safeguard for auditors' independence or are there better alternatives? Would the rule improve audit quality, or would it in fact reduce it? Since there is strong opposition to mandatory audit firm rotation, we must be neutral when analysing the arguments that is used by both sides of the debate. These thoughts outlines to our research question:

- Could mandatory audit firm rotation improve audit quality?

To help us come to a conclusion, we have four sub-questions:

1. How is the mandatory audit firm rotation proposal perceived by the audit profession and financial institutions?
2. How have the United States, Sweden and Italy protected auditor independence and how have they adapted to mandatory audit firm rotation?
3. How is the debate about mandatory audit firm rotation proceeding amongst academics, financial institutions, audit firms, public authorities, organizations and professional bodies after the EU Green Paper was published in 2010?
4. What advantages and disadvantages are perceived for mandatory audit firm rotation?

1.3 The aim of the thesis

The aim of our thesis is to investigate how mandatory audit firm rotation could affect the audit quality. Opinions from the audit profession itself and those who will use the financial statements, namely the financial institutions, are the most interesting to investigate according to us, since we believe that these would be most affected by the rule. In order to best answer our research questions, we will use a triangulation method, which means that this thesis will use three types of studies of audit firm rotation: interviews, investigating the comments on the Green Paper and publicly available articles published by academics and professional bodies. We are also interested of how the debate of mandatory audit firm rotation and auditor independence has developed regarding the European Commission's Green Paper and how the U.S., Sweden and Italy has adapted to the rule in order to protect auditor independence. We therefore identifies and summaries the current regulatory situation in Sweden and in the U.S. and uses Italy as a clarifying example.

1.4 Delimitations

We have chosen Sweden as our basic case country for our study because we will work as auditors here, but since the debate about mandatory audit firm rotation in Sweden is relative small, we will seek information from other EU countries as well. Mainly will sources from United Kingdom be used, and the reason for that is both practical and logical. Practical in the

way that its information is written in English, which decreases the risk for interpretation defaults. It is logical because UK is a large economy in the EU and an important player in the audit and accounting discipline with large professional bodies. In chapter 4, U.S. will be presented because it has great influence on the rest of the world with their choices in accounting and auditing. It will be interesting to see how the U.S. has responded to corporate and financial scandals as well as protected auditor independence. Since Italy is the only country that has a legislation that dictates mandatory audit firm rotation in EU, we are interested in Italy's experience and opinions about mandatory audit firm rotation.

We have excluded the opinions and comments on this subject expressed through the media in order to only present reliable facts. We have focused on relevant articles to achieve a result that is represented by various countries in the world. We explain how we have chosen our articles in section 2.2.2 in the method-chapter and section 5.1 in the literature review-chapter. We have explained how we have chosen the used comments on the Green Paper in section 6.3.1. Further delimitation is that we will not perform a study on key audit partner rotation.

1.5 Disposition

The first part of this thesis gives some background information about the current development within the area as well as an introduction to the topic of the thesis and ending with the research questions that is to be answered. Thereafter, the aim for the thesis is outlined which states the objective of this thesis and the main steps necessary to accomplish it. As final part of chapter 1, we explain our delimitations and the thesis disposition.

Chapter 2 provides a description of the methodology and data collection used in this thesis. The chapter discusses our research method as well as motivates our choice of stakeholders, which have been interviewed for the study, and our selection of the chosen articles. We conclude this chapter by describing the reliability and validity of our research and criticism of the used sources.

Chapter 3 is designed to provide the reader with the theoretical background of the auditor, auditor independence and the stakeholder model. It also describes several of the threats to auditor independence and safeguards that could be used to minimize or eliminate the threats.

In chapter 4, the global context is described through three different countries that have been engaged with auditor independence. It presents how the U.S. have protected auditor independence, as well as describing the current legislation in Sweden and the new proposal that just recently have been published. Italy and Parmalat has been used as a clarifying example of what could happen despite the implementation of mandatory audit firm rotation.

Chapter 5 provides a review and analysis of the academic and professional articles of the subject. The EU Commissions' Green Paper and comments on it is provided in Chapter 6.

The empirical findings of the study are provided in Chapter 7. Furthermore, in the analysis in Chapter 8, we compare the perceived advantaged and drawbacks of the academic and professional articles with the empirical findings, theory, the global context and the comments on the Green Paper.

Finally, in chapter 9 the conclusions of our research are given as well as the proposals for further research within the field.

2. Methodology

In this chapter we will present our research approach, as well as the progress of collecting data and the selection of respondents. The chapter ends with a discussion regarding the quality of the study and criticism of the used sources.

2.1 Research approach

2.1.1. Interpretivistic approach

Epistemology or theory of knowledge is the science of what is or can be considered as acceptable knowledge. There are two different viewpoints of how knowledge can be achieved, and these are positivistic and interpretivistic approach. The aim with this study is to investigate how mandatory audit firm rotation could affect the audit quality and our sub-questions for example concerns different stakeholders' viewpoint and how they perceive and interpret the rule and to identify its advantages and disadvantages. We have chosen Sweden since we will work as auditors here and we are therefore interested of the Swedish situation regarding audit firm rotation. One sub-question concerns how the U.S., Sweden and Italy have protected auditor independence in order to understand how they adapted to mandatory audit firm rotation. In order to best answer our research questions, we will use a triangulation method, which means that this thesis will use three types of studies of audit firm rotation: interviews, investigating the comments on the Green Paper and publicly available articles published by academics and professional bodies. We will therefore have an interpretivistic approach, which is also known as the perspective of interpretation. The viewpoint of interpretivism is based on understanding and interpretation along with that consideration must be given to that the society and people are not objects for scientific studies, but that their social actions must be captured subjective (Bryman and Bell, 2005, p. 29). Hence, given these features, this study constitutes an interpretivistic approach, which is in accordance with our aim. The concept of interpretation-based approach is used by Jacobsen instead of interpretivism, where the essential point is that the reality is not objective, but constructed by humans and must therefore be studied by examining how different people interpret it (Jacobsen, 2002, p. 32). Positivism, opposite to interpretivism, advocates the use of scientific methods when studying the social reality (Bryman and Bell, 2005, p. 26ff). This viewpoint is based on that reality is objective and can thus be studied in a neutral way by using the senses of sight, hearing and touch, as well as objective methods (Jacobsen, 2002, p. 31).

2.1.2. Inductive strategy

Methodology is about how to proceed in order to gather data about reality, whether it is seen as objective or not, according to positivism, or as a human interpretation in accordance with interpretivism (Jacobsen, 2002, p. 34). Based on the interpretivistic approach that we have in this study, it is compatible with the use of inductive strategy according to Jacobsen (Jacobsen, 2002, p. 38). In order to achieve our aim, we started our research by searching for theory within our subject, but since we did not find any substantial theory, we therefore rather tried to create a theory based on empirical data, in accordance with the inductive strategy. Inductive strategy is the opposite of deductive strategy, where instead of testing the theory against empirical data, creates theory based on empirical data. The theory is thus the result of a research effort, which means that the generalized conclusion is deduced based on observations (Bryman and Bell, 2005, p. 25). We have chosen empirical data such as academic and professional articles as well as the comments on the Green Paper, which will be further presented in section 2.2.2, in order to get an indication of what different stakeholders, such as academics, the audit profession, financial institutions, audit firms, investors, public authorities, organizations and professional bodies, in general tend to perceive about mandatory audit firm rotation and its debate. This was also done in order to develop research questions that could be subjects to our empirical study. The aim of the thesis and the research questions were developed with regards that we will work in Sweden as auditors and that we thus are interested in the Swedish audit firms' thoughts about mandatory audit firm rotation and we have for that reason chosen to interview them. The deductive strategy involves derives or deduces hypotheses based on what is already know about an area. They are then subjected to an empirical examination that either confirms or rejects the hypotheses (Bryman and Bell, 2005, p. 23). Deductive strategy is therefore a matter of getting from theory to empirical data, by first acquiring some expectation of how reality looks like, and thereafter collect empirical data to see if the expectations and reality is compatible with each other (Jacobsen, 2002, p. 34). The two mentioned strategies are often considered as exclusively alternative to each other, but in practice it may be difficult to place any type of research in only one of them. Therefore, further possibilities have been illustrated, one of which is abduction. As with the inductive strategy, abduction is based from empirical facts, but as the deductive strategy it does not reject the theoretical notions (Alvesson and Sköldbberg, 2008, p. 55f).

2.1.3. Qualitative research

In light of what is to be investigated and how the study should be performed, one can choose between two methods of data collection, quantitative and qualitative method. In this thesis, we have used a qualitative research approach since it is the method that best relate to our inductive approach and because it is linked to interpretivism. This method has close connections with the interpretive approach of interpretivism as it places emphasis on how individuals understand and interpret the social reality rather than that reality is objective, which is related to our sub-questions. The method also emphasizes the inductive approach, as the emphasis is on generating theory by empirical evidence rather than the opposite (Bryman and Bell, 2005, p. 40). A further reason is that it is consistent with our exploratory research question, as we plan to look deeper into the subject mandatory audit firm rotation rather than to test this issue quantitatively. The reason for this is that we have carried out a descriptive study in order to identify the facts and people's opinions, which means that a qualitative approach is more suitable. Instead of quantity, the focus is on getting nuanced data, and then it is often better to concentrate on a few units, whereas we have concentrated on those we believe would be most affected by the rule, such as the audit profession and financial institutions (Jacobsen, 2002, p. 56 and 73ff). The basic idea behind this method is that by letting interviewees speak in their own words and observe what they say and do, you will get a better impression of how they interpret and perceive certain phenomena. This is instead of giving the respondents complete defined options for the answers, as in the quantitative method, as they are often influenced by the investigator's opinions (Jacobsen, 2002, p. 39). With the help of six interviews, we have tried to find out how the proposal of mandatory audit firm rotation is perceived by the audit profession, audit firms as well as financial institutions, which we believe would be affected by it, and what advantages and disadvantages there is with the rule. To get the most relevant answer as possible, we do not believe that it would be optimal with predefined options for the answers that the quantitative method has. We have therefore used the qualitative method, so that respondents can answer as freely as possible, and without, to a greater extent, be influenced by our views on the subject. In the case with a testing research question, which means that one intends to explore the extent or frequency of a phenomenon, a quantitative method is most suitable (Jacobsen, 2002, p. 56f). The basic starting point for the quantitative method is that reality can be measured by using methods that result in information in the form of numbers, often based on questionnaires or surveys, where the options for answers are given and is answered by many units (Jacobsen, 2002, p.

38f). This method thus emphasizes quantity in the collection and analyzes of the data. Parallels can be drawn to positivism and the deductive strategy, because the method accommodates a perception of that reality is objective and it examines existing theories (Bryman and Bell, 2005, p. 40).

2.2 The collection of data

2.2.1 The primary data

Primary data is the material that the researchers themselves have acquired (Lundahl and Skärvad, 1999, p. 131). It is collected directly from the primary source of information, by including questionnaires and interviews tailored based on the current subject and research question (Jacobsen, 2002, p. 152). The primary data in this thesis is gathered through six interviews from four certified public accountants in medium-sized and large audit firms as well as two investors from financial institutions. The main objective with the interviews was to identify how the respondents perceive the mandatory audit firm rotation proposal and which advantages and disadvantages they see with this policy. This is considered suitable as the aim is to gather nuanced data, where it often is better to concentrate on few respondents (Jacobsen, 2002, p. 56 and 73ff). Since all our respondents expressed a deep desire to remain completely anonymous, no response will be represented by “Auditor and Investor A, B, C” and so on, so that their personal opinions and answers cannot be connected to the respective audit firm or financial institution. The reason for this is that personal opinions sometimes can be misinterpreted and give an inaccurate picture of the firm they represent.

2.2.1.1 The selection of respondents

Since mandatory audit firm rotation is something that would affect the audit profession and audit firms to a great degree, we have chosen to base our starting point on how they perceive it and what they consider to be its advantages and disadvantages. We have also chosen to investigate what other stakeholders to a company, that would be affected by the rule, as investors and banks, think about the subject. We have however excluded to consider what other actors in the Stakeholder model, which is further presented in section 3.1.1, such as companies, suppliers and customers think about the subject due to the time limitation of the

thesis. Several stakeholders' opinions, such as academics, audit firms, investors, public authorities, organizations and professional bodies, have instead been collected by the use of secondary data, as will be explained in section 2.2.2. We have chosen to focus on medium-sized and large audit firms because they have the highest number of audit clients and are therefore those that would be most affected by a mandatory audit firm rotation. In this way, we thought that they might have worked more with the subject than smaller audit firms. Our assumption was confirmed as many of the medium-sized and large audit firms had concerns about the subject and were positive for an interview with us. It is consistent with a qualitative research approach to have a small sample of interviewees. However, we tried to get in contact with several audit firms and other financial institutions, but most of them were either too busy or did not get back to us despite repeated attempts to contact them. The large and medium-sized audit firms and financial institutions that we interviewed in Sweden were KPMG, PWC, BDO, Deloitte, as well as SEB and HSH Debt Advisory ApS.

2.2.1.2 Semi-structured interviews

The approach with qualitative method tends to be much less structured than with the quantitative one, and two forms of qualitative interviews referred by Bryman and Bell, is unstructured and semi-structured interviews. The empirical data has been gathered through semi-structured interviews, which are frequently applied within qualitative research. The reason for this is that we have a specific topic with related sub-questions that we wanted to touch and semi-structured interviews are characterized by that the interviewer has the help of a list of specific topics that should be illuminated. This list is often called an interview guide, and the respondent could answer freely on the various questions. The questions does not need to be asked in the order of the interview guide, and the issues that have not been written down may also be asked as follow-up questions to what the respondent has said (Bryman and Bell, 2005, p. 361ff). It also felt safer to have an interview guide to support interviews of this type to give a professional impression since we only have performed interviews like this one time before, in our candidate thesis. At the same time, we had no concrete opinions about the answers that we would receive during the interviews. Therefore it was important to us that the respondents could answer freely, and that we had the opportunity to ask follow-up questions, and to change the order of the questions during the interviews. Unstructured interviews, the opposite of semi-structured interviews, tend to resemble a normal conversation, where it

could be that the interviewer only asks one question about a subject that the respondent is to answer freely about. The interviewer often makes use of loose notes on a number of topics as a support during the interview, and reacts only at certain points in the respondent's answers which might be worth a follow-up question (Bryman and Bell, 2005, p. 361ff). As semi-structured interviews best suited our qualitative approach, we developed an interview guide based on academic articles that were relevant to our topic, and we basically asked the same questions in the different interviews with the various audit firms and financial institutions. The interview guide has been revised several times because of the knowledge we have gained while working with this thesis, which has led to that the first draft of the interview guide has, during the process with this thesis, been revised a couple of times before we reached our final version of the interview guide. We have only included the final revised version of the questions and the interview guide is found in Appendix 1, with both the questions for the audit firms and for the financial institutions.

2.2.1.4 Approaches and follow-ups

According to Lundahl and Skärvad, it can take a long time from the first contact with a company to the time for the interview. It is better to contact the respondent by the use of telephone rather than e-mails and letters, since the latter often fall into the category of dormant and unimportant cases (Lundahl and Skärvad, 1999, p. 118f). We therefore initiated already in the first week to look up current audit firms using various search engines on the Internet and decided whom we would contact. We then decided to call the various selected respondents to book appointments. However, the process of booking meetings with the audit firms that we wanted to interview was relatively difficult, as the time in the spring is very busy for many. It has simultaneously been relatively hard to get in touch with the right people for the reason that they have often been occupied and on several occasions we had to send an email to make an appointment. Many of the selected respondents were still either too busy to meet us or did not get back to us despite repeated attempts to contact them, which most likely meant that they did not have enough time to have an interview with us. A small sample of interviewees is on the other hand consistent with a qualitative research approach. The response when a contact finally had been established with the right person has, however, been positive and many appreciated the fact that we called them first and not only got in touch via email. The interviews took place at the respondents' meeting rooms in Gothenburg. All

interviews have been personal meetings where we wanted to be able to observe the respondent during the interview, make clarifications and follow-up questions, which is difficult with an interview by the use of e-mail or telephone. We have also sought the most possible spontaneous answers and reactions from the respondents, whereof we did not sent our questions in advance unless they have expressed a desire for it. The interviews were recorded on one of our mobiles, after the respondents' consent, to obtain a more natural contact during the interview, and we also documented some of the answers during the interview if the technology would not work. The average time for the interviews was one hour, and we began each meeting to inform our intent with the interview. We asked all respondents if we could come back in case we needed to ask further questions, and the interviews were then transcribed individually. The interviews were conducted in accordance with the practical recommendations made by Jacobsen (Jacobsen, 2002, p. 164ff).

2.2.2 Secondary data

Secondary data is known as second-hand data that consist of information that others have collected previously, with other objects and purposes than the own study (Lundahl and Skärvad, 1999, p. 131). Secondary analysis is according to Bryman and Bell, the process of collecting and analyzing secondary data, and the benefits of this include that it saves resources, get access to high quality data and allows for cross-cultural analysis (Bryman and Bell, 2005, p. 231ff). This has been some of the main reasons why we have used secondary data to the extent that we have done. Since mandatory audit firm rotation is something that does not exist in Sweden, there has been a necessity for us to use secondary data, particularly regarding the possible advantages and disadvantages for the audit market, since there does not exist any real effects in Sweden. Since the debate therefore is relatively small in Sweden, we have also sought information from countries such as Italy, UK and U.S. We have chosen parts of our secondary literature because it can be related to our subject and our research questions, and in a good way illustrate and explain the various aspect of what the thesis is about. Other parts of the secondary literature have been used to support how we should proceed during the writing and the suitability of empirical data and how it should be obtained. For example, we used various academic and professional articles on the subject mandatory audit firm rotation in different contexts, such as in relation to auditor independence. The selected academic and professional articles have been produced in different countries in the world and the research is

about different countries. This procedure has been used to acquire a comprehensive overview of the perceived advantages and disadvantages on the subject worldwide. We have found the different academic and professional articles using various search terms such as “mandatory audit firm rotation”, “audit firm rotation” and “firm rotation” on different search engines on the internet such as Google Scholar and Lund University’s search system for library materials, known as Summon. We have used a triangulation method in order to gather our primary and secondary data. The first of the three studies that have been used is that we have chosen to do an empirical study from two stakeholders’ perspective through interviews with certified public accountants and investors. The other two studies have been used to gather other stakeholders’ opinions via the use of secondary data. These two studies have been performed to investigate the comments on the European Commissions’ Green Paper and publicly available articles published by academics and professional bodies. The three studies have been used in order to compare the different opinions from the comments on the Green Paper with the performed interviews as well as with the chosen articles’ perceived advantages and drawbacks. In total, our three studies include stakeholders such as academics, the audit profession, financial institutions, audit firms, investors, public authorities, organizations and professional bodies. We have also investigated how the U.S., Sweden and Italy have protected auditor independence in order to see how they have adapted to the rule. Other literatures we have used are books and documents about the auditor and independence, books of stakeholder model, and various literatures regarding methodology and how an academic thesis is written.

2.3 The quality of the study

Reliability and validity are important criteria when it comes to highlight the quality of a research. However, it has been discussed whether these criteria are useful in qualitative studies, especially when the criterion validity and its definition contain the significance of measurement, which to a large extent is linked to quantitative studies (Bryman and Bell, 2005, p. 304). Nevertheless, many researchers believe that the criteria can also be used in qualitative studies because it can be confusing to find new concepts that say the same as the existing ones (Jacobsen, 2002, p. 21). According to Bryman and Bell, many qualitative researchers have a tendency to use the criteria validity and reliability primarily in the same way as the quantitative researchers, and for this reason we use them in the discussion of this thesis’ quality (Bryman and Bell, 2005, p. 306).

2.3.1 Reliability

Reliability refers to a study's accuracy and credibleness. The concept's intention is to determine if the results of a study are repeatable, or if it is affected by temporary or random factors. Replication is another criterion that is similar to reliability, which also is the possibility to reproduce another researcher's conclusions and findings (Bryman and Bell, 2005, p. 48). When adapting the criterion reliability to a qualitative research, the aspects of external and internal reliability have been highlighted. External reliability concerns the degree to which a study can be replicated, something that can be relatively difficult in a qualitative research because the social conditions prevailing at a time can be difficult to recreate at a later date. The meaning of internal reliability is that those who are performing the studies agree on how to interpret what they hear and see (Bryman and Bell, 2005, p. 306).

Whether it is possible to reproduce our concluding results is rather difficult to answer. As the number of interviews carried out is relatively few, and that the responses we received are based on the respondents' personal opinions at the current time, it may be possible that a similar study would not reach an identical conclusion. This especially if a similar study would be carried out at a later date, for example, in ten years, when possibly Sweden has introduced a mandatory audit firm rotation. This leads to that the respondents' opinions and responses had been somewhat different since the advantages and disadvantages of the rule probably would be more significant for the companies. Despite this, we have tried to contribute to the external reliability of this research by accurately describing how we proceeded in gathering our information and data. We thus believe that if the same questions were asked from our interview guide to the respondents within the nearest future and that a mandatory audit firm rotation has not been introduced in Sweden, that similar answers and reactions would be obtained. Our contribution to the internal reliability is that we have tried to avoid the so-called interview effect, in that we both have been involved in all the interviews and at the reading of the transcribed material. We have mainly asked the same questions to all respondents, and tried to ask open questions to avoid leading the respondent in a certain direction. We therefore believe that the received answers and the representation of the interviews only to a small extent have been affected by our own personal interpretation (Jacobsen, 2002, p. 269ff). A further aspect of the criterion of reliability is the study's credibility, which means that it is performed in a proper and credible way (Jacobsen, 2002, p. 22). We have tried to stay within the framework of the one recommended in the various textbooks on the approach of having a

professional interview as possible. Hence, we believe that the thesis has been performed correctly and in accordance with the guidelines that exist for an academic thesis.

2.3.2 *Validity*

Validity is about the empirical data and that it is relevant and valid. This means that what is measured in the studies are perceived as relevant and that it is what you actually has had the intention to measure, and that what is measured with few actors also applies to several (Jacobsen, 2002, p. 21). In adapting the concept of validity to a qualitative research, the word has been divided into the aspects of external and internal validity, with the first matter is whether the result from a limited area can be generalized to other social situations and environments. Internal validity is about that the observations a researcher does should be consistent with the theoretical ideas and concepts that the researcher develops (Bryman and Bell, 2005, p. 306).

It is difficult to say how well the results that we have reached in this paper can be generalized, and with it, how high the external validity is. This is because our study can be compared to a sample as it is based on a limited number of interviews with the audit firms and financial institutions that have had the time and opportunity to meet us, and that the answers and reactions that we have received has largely been the respondents' personal perceptions. We have simultaneously experienced, which we will elaborate in the analysis, that most audit firms have fairly similar views about the subject. This makes it likely to believe that even other audit firms, additional to those that we have interviewed, generally mean the same, which again could make our results, to some extent, representative of the auditing profession and the financial institutions (Jacobsen, 2002, p. 266f). Regarding the internal validity of the thesis, we believe that this is good, because the result we obtained using our empirical data is what we originally intended to measure. We also sought to have a good connection between empiricism and theory, although the literature on the specific subject has been very limited. Therefore, it has also been important for us to connect our empirical work with the academic and professional articles that we have in the paper. Our intention has also been to interview the representative audit firms, financial institutions and their investors and professionals within the firms, to the extent that it has been practicable. With this regard, it was important for us to try to get meetings with people with knowledge and experience about the subject,

rather than focusing on the title such as owners or partners of the company. This has been done in order to receive the maximum possible extent to get access to first-hand information. However, we have seen it as an essential requirement for the validity of the thesis that the respondents from the audit firms have been certified public accountants (Jacobsen, 2002, p. 256ff).

2.3.3 Criticism of the sources

According to Rienecker and Jørgensen, one should be critical of the sources used in a thesis. This means that you have to ask yourself about the sources, among other things if they have been able to answer the research question well enough, if they were sufficiently reliable to serve as an example and used as a basis, and if they were objective in relation to other sources (Rienecker and Jørgensen, 2008, p. 257f). We have, as mentioned earlier, tried to identify those respondents who we consider to represent the respective audit firms' and financial institutions' views in a satisfactory manner. The same applies to the secondary data that we have used, where we tried to be critical, given to find impartial writers. At the same time it has been difficult to find information on our specific topic and regarding its advantages and disadvantages in the world since the academic, and thereby the professional, articles can be characterized by the authors' own opinions rather than reliable facts because it is a new phenomenon within research. Regarding the articles that we have used, we have been recommended on where to search to get acknowledged articles. Most of the articles are mentioned in each other, which gives credibility to the researchers and that they have great experience on the subject. Lundahl and Skärvad thinks it is especially important to be critical of secondary data, since the sources that they have been gathered from, could among other things be incomplete and biased (Lundahl and Skärvad, 1999, p. 134). We have tried to take this into account by using some of the literature that is scientific and thus objective in its image, but without being characterized by a biased opinion. Meanwhile, we have in some areas made use of articles from various professional organizations and the journal *Balance*, which has only been used once when presenting the stakeholder model, whose objectivity may be questioned, but we have tried to relate critical to this information and inform the reader when we refer to specific comments.

3. Theory

In this chapter we first define the role of the auditor and the stakeholder model. We thereafter present independence and its meaning. Finally, we describe the different threats to independence and the safeguards used to eliminate or minimize these threats.

3.1 The role of the auditor

It is necessary that the review and audit is performed critically and with objectivity. The reason for this is that the auditor needs to be independent towards the audit client in order to confirm that the audited information is providing value to the company's stakeholders and that is useful and reliable (Porter, Simon and Hatherly, 2008, p. 9ff). The auditor is thereby an independent link between management and the users who need to rely on the financial statements. Independence is therefore seen as an important way for ensuring that the work performed by the auditor is credible (Porter, Simon and Hatherly, 2008, p. 65).

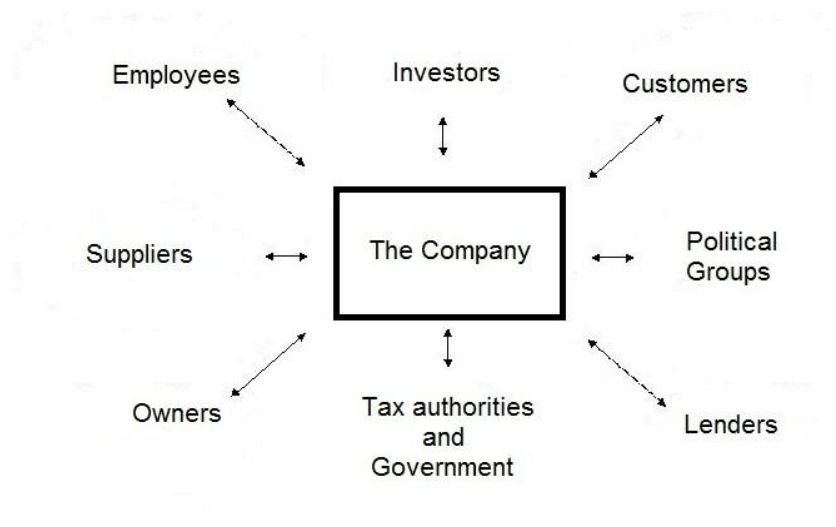
“The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.” (International Standard on Auditing 200, 2010, p.

72)

For the auditor to be independent, a third party and society need to perceive the auditor as being free from relationships and situations that impair or could impair the auditors' independence and objectivity (Porter, Simon and Hatherly, 2008, p. 66). A considered threat that could impair the auditors' independence is the provision of other services than the audit, acknowledged as non-audit services. Cases like Enron in the U.S. and Parmalat in Italy are known as were the independence and objectivity of the auditors has been impaired (Porter, Simon and Hatherly, 2008, p. 102), cases we will present in the chapter titled “the global context”.

3.1.1 The Stakeholder model

We have used the stakeholder model since we consider it to be more appropriate for our subject than for example the agency theory. An implementation of mandatory audit firm rotation would not only affect the audit firms, it would also have an influence on the audited company's different stakeholders. The audited company would for instance be affected by higher audit costs in the earlier years of the arrangement (ICAEW, 2002, p. 2f) and this would have an effect on the financial statements as well as on the stakeholders' decisions that has been based on the audited information.



The Stakeholder model (our own interpretation)

Stakeholders in the model may differ slightly in different literatures depending on the author's interpretation. Eight categories of interest that a company often is acknowledged to have some sort of connection with are: owners, employees, customers, government and tax authorities, suppliers, investors, political groups and lenders. This model assumes that a company strives to create a stable setting to its environment, a sense of balance to achieve a satisfactory financial gain for the company. The relationship a company has with its stakeholders is a mutually dependent relationship and the reason for this is that there is an exchange of inter alia information, services and products. Stakeholders request for rewards that exceed the contributions that the company receives from them. According to this model, the company aims to satisfy stakeholder expectations, but at the same time, the company wants to fulfill its own aims as far as possible without getting into conflict with its stakeholders. Consequently, this requires that the management occasionally have to make compromises and prioritizing the stakeholder needs, so that an appropriate balance emerges between their demands and the

company's future development. For instance, the state contributes with education and infrastructure and in return, they desire taxes and job opportunities. From a management's point of view, it is important to have the stakeholders' confidence, as they largely depend on the stakeholders, especially from a financial aspect. This, together with stakeholder needs for accurate information from the companies, creates a demand for external auditing by an auditor (Ax, Johansson and Kullvén, 2005, p. 38ff).

Another aspect in relation to the stakeholders is discussed by Thomas Carrington (2009). He argued about the potential problem that management does not want to disclose information that might have a negative impact on the company, and that this might lead to that the stakeholders would make the wrong decisions because they do not have access to this information. The auditor would then have to act as an intermediary of the information between the company and its various stakeholders, and from that perspective the audit will be a practical way to reduce this uncertainty (Thomas Carrington, 2009).

3.2 Auditor independence

The independence of auditors is of great significance as the main reason for an introduction of mandatory audit firm rotation is to protect and enhance the independence as a safeguard (ICAEW, 2002, p. 11). The regulation of the audit and the development of the accountancy profession are performed by different bodies around the world and one of these is the International Federation of Accountants, IFAC. 2.5 million auditors is represented by this global organization which acts within 127 countries and jurisdictions where a Swedish body called Far, which we will present in the section about Sweden in chapter 4, is an example of IFAC's 167 members. IFAC acts like a safeguard for the public interest through the support of various areas such as ethics and accounting education as well as the development of international standards with high quality. The independent International Ethics Standards Board for Accountants, IESBA, is supported by IFAC (IFAC, 2011). IESBA develops ethical standards with high quality, for instance for auditor independence and guidance for the use by professional accountants and have developed The Code of Ethics for Professional Accountants (IFAC, About IESBA). This code is used in IFAC's Handbook of the Code of Ethics for Professional Accountants, hereafter IFAC's Handbook, which states that auditor independence is divided into both independence in mind and independence in appearance. The former, independence in mind, is primarily associated with the use of professional

scepticism and objectivity by the auditor and to be able to express an opinion without the influence of others. The latter, independence in appearance, is associated with the fact if the auditor has used all available measures to maintain his independence and objectivity and thereby avoiding the possibility that a reasonable and well-informed third party would believe that the professional scepticism and objectivity has been impaired (IFAC, 2010, p. 42).

3.3 Threats to independence

IFAC sets the various threats in a broader context than the EU Recommendation (Statutory Auditors' Independence in the EU: A set of Fundamental Principles (2002)), and that they are threats to the compliance of professional accountants with the central principles of professional ethics, which are objectivity, professional competence and behaviour, integrity, due care and confidentiality, and not just as maintaining auditors' independence. We have therefore chosen to use IFAC's Handbook as our basic source on independence throughout the thesis and we have only used the EU Recommendation (2002) for explanatory value since they are quite similar (Porter, Simon and Hatherly, 2008, p. 106).

Auditors are exposed to different threats and it is stated in IFAC's Handbook that auditors should detect any possible threats and evaluate the identified threat's importance and consequences (IFAC, 2010, part A, p. 9). The greatest threat to auditors' independence that regulators want to reduce to an acceptable level or eliminate, with mandatory audit firm rotation as a safeguard, is the *familiarity (or trust) threat*. This threat could arise when there has been a too near or long association between the auditor and its client. The risk is that the auditor might accept the clients' work despite errors or be too influenced by the clients' interest and thereby not be sufficiently critical in the audit review (IFAC, 2010, p. 12).

Two other threats of great association to auditor independence are self-review and self-interest threat. The *self-interest* threat concerns the possibility where the auditor might be influenced to affect the audit's outcome if there is a direct or indirect interest for the auditor in the clients' firm that could be financial or of other interests (Porter, Simon and Hatherly, 2008, p. 105). This threat is mainly associated with the non-audit services and the audit firms' economic dependency of it. There is a significant risk that the auditor becomes less critical in the audit review if the fees from the non-audit services have a strong connection to an audit firm's turnover (Porter, Simon and Hatherly, 2008, p. 127). A situation where the self-interest threat

becomes clear in relation with the mandatory audit firm rotation is when there is a probability for the audit firm to worry about the concernment to lose an important client (IFAC, 2010, part B, p. 22). Another situation with the self-interest threat is when an economic dependence is deemed to exist according to the European Commission's Recommendation (2002) if an inappropriate share, each year during a five-year period, of the audit firms' total revenues comes from the same client (Kommissionens Rekommendation 2002/590/EG, p. 32).

The *self-review threat* is associated with if a new member of the audit firm and team has had influence on the financial statements through a recent employment in the audited company (IFAC, 2010, part B, p. 23). It also concerns the risk that the auditor has to evaluate and review work from non-audit services, such as preparing the financial statements, that has been performed by other partners in their own firm. This could also be the case when an audit firm might give advice on a new accounting system and thereby is involved in the audit as well as in other services for a client. In situations such as these, the auditor's independence could be questioned by the company's stakeholders as the objectivity of the auditor have been impaired or might have been impaired. In the audit process, the auditor might manage to sustain independent, but this could be hard to prove and for the stakeholders to accept (Porter, Simon and Hatherly, 2008, p. 127).

The *intimidation threat* in IFAC's Handbook is where different actors are trying to put pressure on, actual or perceived, and influence the auditor, such as the audited company's management or the client. This leads to that the auditor is prevented from being objective in the audit (IFAC, 2010, p. 12). The *Advocacy threat* is another risk that is mentioned in IFAC's Handbook. The risk is that the auditors' objectivity might be questioned, at least by a third party, due to that the auditor has taken on the role of representing the client (IFAC, 2010, p. 12). This could be the case if the tax authorities gives an audit client a lawsuit were the auditor needs to represent the audit client because they have given tax advice to them (Porter, Simon and Hatherly, 2008, p. 128). A risk that is mentioned by Porter, Simon and Hatherly (2008) is the *management threat*. The auditor might become closely aligned with management interest if the management needs to base their judgments on the work derived from non-audit services. A situation that audit firms are forbidden to perform, is taking decisions on behalf of the audited company's management where the auditor's independence would definitely be impaired or perceived to be impaired (Porter, Simon and Hatherly, 2008, p. 105).

3.4 Safeguards

It is stated in IFAC's Handbook that auditors should minimize the threats to a level that is acceptable or eliminate them by applying safeguards (IFAC, 2010, part A, p. 9). Different bodies and organizations have created the mentioned safeguards in IFAC's Handbook, such as by the regulation, profession or legislation. This include different requirements for being able to practice as an auditor, such as the required education, experience and continues professional development, and training. Other safeguards are the use of professional standards, regulations regarding corporate governance, and also disciplinary procedures and monitoring by professional or regulatory bodies (IFAC, 2010, p. 12).

The audit firm is required to have a leadership that develops policies considering the necessity of identifying threats, evaluating them and which safeguards to apply to reduce or eliminate the threats and which clearly points out the significance of the principles in the IFAC's Code of Ethics, and (Porter, Simon and Hatherly, 2008, p. 111). Having a rotation of the audit teams' senior members is considered as a safeguard. Another example of safeguards, especially related to the audit engagement, particularly when the audit firm performs the audit as well as other services, is that a professional auditor reviews the non-audit services that have not been involved in any services to the client (IFAC, 2010, part B, p. 25f).

Three suggestions for safeguards that could strengthen the auditor independence is mentioned in Porter, Simon and Hatherly (2008), whereas the first is the possibility that the state, an independent oversight body or a state agency appoints the auditor to the company. Criticism that has been expressed against this suggestion is that the state could control the auditors and the audit function, and that their work therefore could become a political issue and the professional independence would be lost (Porter, Simon and Hatherly, 2008, p. 132f). In Sweden, as we will discuss in the next section, the client selects the auditor, or if it is a public company, the auditor is appointed by the shareholder's general meeting (Aktiebolagslag (2005:551), chapter 9, 8 §). A second suggestion by Porter, Simon and Hatherly (2008) is to let a designated panel of shareholders having the responsibility to appoint the auditor, instead of letting the shareholders as a body perform the task. Criticism against this suggestion is how to select the panels' members and that they would have access to unavailable, to other shareholders, information which could lead to insider trading (Porter, Simon and Hatherly, 2008, p. 133f). Porter, Simon and Hatherly's third suggestion is regarding mandatory rotation of the audit teams' senior members, or even mandatory audit firm rotation (Porter, Simon and

Hatherly, 2008, p. 134f). This is already, to some extent, a reality in the European Union, where the senior members, counted from the beginning of the engagement, in the audit team are to be replaced within seven years (Kommissionens Rekommendation 2002/590/EG, paragraph 10.2a). Since the public trust declined after the worldwide scandals, the Government in the United Kingdom, hereinafter as UK, established a “Coordinating Group on Audit and Accountancy”, hereinafter as CGAA, to consider a range of reforms (CGAA, 2003, p. 7). In 2003, the CGAA did not recommend mandatory audit firm rotation as a step to enhance the trust, but they did recommend an increase in the frequency of the rotation of audit engagement partner to five years maximum and for other key audit partners it is seven years (CGAA, 2003, p. 24f).

Mandatory audit firm rotation, which will be performed after a specified period, is today only a legal requirement in Italy, India, Singapore, South Korea and Brazil (Cameran, Di Vincenzo and Merlotti, 2005, p.6ff). The discussion of the perceived advantages and disadvantages for mandatory audit firm rotation will proceed later in chapter five where a literature review of various articles will be presented.

3.5 Table of the chosen theories

	The selected theory	Why we chose the theory	Where the theory has been used
1	The role of the auditor	We have chosen to describe the auditors' importance for the organizations and to the financial statements reliability to give an understanding of the auditor's role.	This theory has been used in chapter 3 to describe the auditor's role and to introduce the reader to the subject.
2	The Stakeholder model	This is presented in order to describe the stakeholders' role and their importance to this thesis.	This theory has been used in chapter 3 to describe the auditor's role between the stakeholders and the organizations. It has also been used in chapter 2 in order to select which stakeholders that are important to the subject mandatory audit firm rotation and this thesis. The chosen stakeholders can be found throughout the thesis.
3	Auditor independence	This is presented due to its relevance for the subject and that a mandatory audit firm rotation have been suggested to protect the auditor's independence.	This theory has been used in chapter 3 to describe auditor's independence and to introduce the reader to the suggestion that mandatory audit firm rotation could be seen as a safeguard to the independence. This is also touched upon throughout the thesis and is also used in one of the sub-questions.
4	Threats to independence	This is described to let the reader know which threats exist to the independence of the auditors.	This theory has been used in chapter 3 to present the different threats that exist today towards auditor's independence. This is also touched upon in the analysis in chapter 8 and in the conclusions in chapter 9.
5	Safeguards	This is described to let the reader know which safeguards exist to the independence of the auditors. Mandatory audit firm rotation is here presented as a suggestion to become a safeguard.	This theory has been used in chapter 3 to introduce the reader to the subject of which safeguards exist and which suggestions that are proposed to become safeguards. This topic is also touched upon in the analysis in chapter 8 and in the conclusions in chapter 9.

4. The global context

We will here present three different countries that have been engaged with auditor independence and thereby present a global context. We will first describe how the U.S. have protected the independence of auditors after the Enron-scandal, followed by a section for our basic case country Sweden and how the situation in Sweden is today regarding auditor independence and mandatory audit firm rotation. Thereafter we will describe Italy and the Parmalat-scandal due to its relevance for the subject.

4.1 The United States' protection of auditors' independence

After recent years' accounting scandals worldwide, the audit profession has been subject to criticism. In 2001, the Enron collapse in the U.S. had a major impact on auditing regulations and for that reason, major parts of the legislation were issued from the regulating bodies. In order to restore the public trust in the audit process, the regulations included more severe penalties and larger enforcement budgets was imposed to protect from fraudulent behaviour in the financial markets (Pott, Moch and Watrin, 2009, p. 209ff).

The Sarbanes-Oxley Act, hereinafter as SOX, was issued in 2002 in the U.S., which required that public companies' auditors should be subject to an independent and external attendance. These auditors were, in the U.S., self-regulated before the SOX. The Congress established the Public Company Accounting Oversight Board, hereinafter as PCAOB, a non-profit organization that was created by the SOX. By overseeing public companies' audit, PCAOB promotes independent audit reports with accurate and reliable information to serve and protect investors and the public interest. The authority to oversee the PCAOB is conducted by the U.S. Securities and Exchange Commission, hereinafter as SEC. This means the PCAOB needs the SEC's approval when they want to introduce a new rule, budget or standard (Public Company Accounting Oversight Board, About the PCAOB).

To maintain both independence in appearance and in mind, regulatory requirement, such as prohibitions on the provision of concurrent non-audit services and the application of audit partner rotation, were implemented. On the other hand, Pott, Moch and Watrin believes that more audit regulation and requirements only is an implied way of enhancing the failed audit function, and their research does not point out one specific requirement that would most effectively and successfully restores the trust to the audit function. But they did conclude in their article "Review of empirical research on rotation and non-audit services: auditor independence in fact vs. appearance" that in order to maintain auditor independence, a

combination of multiple requirements might be demanded to minimize or eliminate the existence of several threats to auditor independence (Pott, Moch and Watrin, 2009, p. 209). Nonetheless, when the question about an introduction of *auditor* rotation or *audit firm* rotation was raised in the U.S., in connection with the introduction of the SOX in 2002, only internal *auditor* rotation was introduced. The reason for this was because the U.S. Congress felt that the previous research that existed in the area of *audit firm* rotation was too limited and not sufficient to predict the potential impact on the American market (GAO, 2003, p. 2).

4.1.1 Enron and the following legislation of SOX

In 2000, SEC was encouraged to adopt rules prohibiting non-audit services inconsistent with auditor independence due to several major instances of misstated earnings (Lindberg and Beck, 2004). This was the result of SEC's growing concern during the 1990s about the likely impairments on auditor independence caused by the provision of non-audit services. Therefore, new strict rules for independence were introduced, which in turn would limit the services that could be offered to and provided for SEC registrant audit clients by their auditors (Porter, Simon and Hatherly, 2008, p. 128f).

Auditor independence is a contributing factor to financial statement user's confidence on the financial reporting process because it ensures quality audits (Lindberg and Beck, 2004). If a non-audit relationship between an audit client and their auditor expands without regulation, the result of this could affect the user's reliance of the financial statement as well as on the objectivity of the auditor (SEC, 2001, Part III, C, paragraph 1). Two sorts of concerns of the auditors' independence is to be raised when an auditor have an interest to preserve or establish a relationship of non-audit services with its audit client. First, inherent conflicts could be created when the auditor provides particular non-audit services that are incompatible with the auditors' objectivity, for example when the services require the auditor to audit his own work. Second, the economic incentives creates an interdependence between the auditor and his audit client, and if the auditor should offend the client, then the cost would be greater to the auditor if he has much at stake when dealing with the client. This would especially be the case when the relationship with the non-audit services, on top of the audit relationship, has the potential to generate significant revenues (SEC, 2001, Part III, C, paragraph 2 and 5).

In the first instance, a rule with four general principles was established for SEC to look at, and these are whether a relationship or the provision of a service:

- (a) Creates a mutual or conflicting interest between the accountant and the audit client;*
- (b) Places the accountant in the position of auditing his or her own work;*
- (c) Results in the accountant acting as management or an employee of the audit client; or*
- (d) Places the accountant in a position of being an advocate for the audit client (SEC, 2001, Part IV, A).*

To know if an auditor is independent or not, SEC has provided a bright-line test which states that an auditor is not independent if he acquires the interests, engages in the transactions or maintains the relationships specified in the rule mentioned above (SEC, 2001, Part IV, C). Nine rules concerning non-audit services inconsistent with auditor independence are underlined by the four general principles, which subsequently were made into law by SOX. The result was eight non-audit services that auditors are prohibited from providing to their SEC registrant audit clients, since the rules regarding management functions and human resources were consolidated into a single-rule (Lindberg and Beck, 2004). These are:

- 1. Bookkeeping or other services related to the audit client's accounting records or financial statements.*** *An audit firm cannot maintain or prepare the audit client's accounting records or prepare the audit client's financial statements that are either filed with SEC or form the basis of financial statements filed with SEC. (An exception includes providing services in emergency situations, provided the accountant does not undertake any managerial actions or make managerial decisions).*
- 2. Financial information systems design and implementation.*** *The auditor cannot operate or supervise the operation of the client's IT systems. However, the auditor could provide IT consulting services if certain criteria are met.*
- 3. Appraisal or valuation services or fairness opinions.*** *Restrictions on these services apply only where it is reasonably likely that the results of any valuation or appraisal would be material to the financial statements, or where the accountant would audit the results.*

*4. **Actuarial services.** Actuarial-oriented advisory services are limited only when they involve the determination of insurance company policy reserves and related accounts.*

*5. **Internal audit services.** An audit firm is allowed to perform up to 40 percent (measured in terms of hours) of an audit client's internal audit work. (This rule provides an exception for smaller businesses by excluding companies with less than \$200 million in assets).*

*6. **Management functions.** An auditor's independence is considered impaired when the accountant acts, temporarily or permanently, as a director, officer, or employee of an audit client, or performs any decision-making, supervisory, or ongoing monitoring function for the client.*

*7. **Human resources.** An auditor is not able to recruit, act as a negotiator on the audit client's behalf, develop employee testing or evaluation programs, or recommend, or advise that the client hire, a specific candidate for a specific job.*

*8. **Broker-dealer services.** An auditor cannot serve as a broker-dealer, promoter or underwriter of an audit client's securities.*

*9. **Legal services.** An auditor cannot perform services for an audit client in which the person providing the services must be admitted to practice before the courts of a U.S. jurisdiction (Lindberg and Beck, 2004, p. 6).*

The collapse of Enron in 2001 was followed by the collapse of one of the big five audit firms, Arthur Andersen in 2002. One of the main reasons was Andersen's failure to conduct proper audits of Enron's financial statements, due to the absence of a required level of auditor independence (Porter, Simon and Hatherly, 2008, p. 45ff). Another reason was that more than half of the weekly billings of \$ 1 million, which was delivered by Arthur Andersen to Enron, were due to the provision of non-audit services. For instance, Andersen did consulting work for Enron and was also a routine provider to the company's accounting staff. Furthermore, Andersen had numerous members in the Enron management team and retained several of its staff members in Enron facilities (Cabello et al, 2006, p. 24).

Nevertheless, the provision of non-prohibited non-audit services, including tax services, is allowed, but the concerned service needs to be disclosed in the annual report of the company and to be pre-approved by the client's audit committee (Porter, Simon and Hatherly, 2008, p. 48). A committee of the board of directors, or its equivalent, is known as an audit committee.

The majority are non-executive directors which are having delegated responsibility from the board for inter alia overseeing the external audit (Porter, Simon and Hatherly, 2008, p. 146). The PCAOB adopted a rule in 2008 requiring registered or listed, in the United States, public companies' auditors to describe in writing the relationships between the audit firm and the company that may bear on the audit firm's independence to the audit committee, before continuing or accepting a new audit engagement (Porter, Simon and Hatherly, 2008, p. 129).

4.2 Mandatory audit firm rotation in Sweden

4.2.1 National bodies in Sweden

In Sweden, the national body Far was established in 2006 through the coalition between the Swedish Audit Community (SRS) and the Association for Authorized Auditors (FAR). Far is an organization for auditors and consultants who develop the profession by giving clear rules and reliable information, through inter alia education and recommendations. Far is working at a national level as well as internationally and has about 6500 members that work within different areas, for instance tax consultants, approved public accountants, authorized public accountants, and other highly qualified specialists (Far, Professional association for auditors and advisors).

The national governmental body is the Supervisory Board of Public Accountants (RN). The Swedish audit activities, which are performed by approved and authorized public auditors or auditing firms, are ensured by RN to have a reliable quality that strengthens the statutory audits' credibility and meet the requirements of high ethical standards (Supervisory Board of Public Accountants, About RN). RN examines questions concerning the approval, authorization or registration according to the Auditors Act (RL) as well as disciplinary and other actions against inter alia auditors. In addition to this, RN also has the responsibility to ensure the interpretation and the development of the concepts "god revisionsssed" and "god revisorsssed", that is following law and auditing standards (Revisorslag 2001:883, 3 §). RN thereby follows the developments in the auditors' field and especially pays attention to new international, as well as national, conditions that could have any implications for the supervision of auditors and audit firms (Supervisory Board of Public Accountants, About RN).

4.2.2 Sweden's protection of auditors' independence

According to RL, auditors in Sweden are entitled to exercise audit activities, but not any other activities that would disrupt the trust for the auditor (Revisorslag (2001:883), 25 §). It is stated in the Companies Act (ABL) that the auditor shall review the accounting and financial statements of the company as well as the management by the board of directors and the chief executive officer. This examination and review shall be as comprehensive and detailed as generally accepted auditing standards require. In other words, the examination shall be performed according to "god revisionsed" (as explained above) (Aktiebolagslag (2005:551), chapter 9, 3 §). To ensure the audits quality, the auditor has his professional competence, impartiality and independence. Through the explained examination, the auditor creates a justified and necessary confidence in the financial information, which is essential because it is crucial for a functioning economy and because it is provided to shareholders and third parties. This is why it is important that the audit is performed in an objective manner (Proposition 2000/01:146, p. 51ff).

As mentioned in section 3.2, auditor independence can be distinguished between independence in mind and in appearance. According to Pott, Moch and Watrin, the first classification is associated to the audit opinions that have been issued, the restatements of financial data, actual behaviour of auditors, quality and earnings management. The second classification is connected to the association between the capital market reactions towards a client's earnings, defined as the avoidance of substantial circumstances and/or facts that would reasonably cause an assumption that a firms, or auditors', objectivity, integrity or professional scepticism has been compromised for an informed and rational third party (Pott, Moch and Watrin, 2009, p. 212, 216 and 222).

The Proposition 2000/01:146 regarding the auditors' independence, which is connected to RL, describe independence in mind as the auditor's "real" independence and impartiality, the ability of the auditor to take all relevant circumstances into account to the audit work and to exercise the greatest possible objectivity. This is primarily equivalent to the definition of the word made by IESBA, which can be found in IFAC's Handbook. Independence in appearance is defined by the importance that the surroundings have trust in the audit in order for it to function in the society and in the capital market. This is the reason why it is significant that there are no existence of any circumstances which makes the surroundings questioning the ability of the auditor to be objective, inter alia personal relationships and non-audit services

(Proposition 2000/01:146, p. 57). RL outlines the auditors' role and what he is allowed to do, including activities such as review and some advisory activities. The auditor can perform a review of the management of a company or financial information that follows the constitution, statutes, or contract, which culminate in a report that is intended to provide data for estimation even for someone other than the client. The auditor can also give assistance and advice based on the observations made during the audit (Revisorslag (2001:883), 2 §, paragraph 8).

The core activity of the auditors, the statutory audit, was the starting point for the rule-setters when determining the definition of audit. Various proposals were given on what activities that should be considered as an audit activity, such as statutory audit, additional statutory engagements, audit consultation, additional contractual engagements and other reviews than statutory audit. Based on the society's needs and perspectives, only activities that had a reason to be constitutionally regulated were included. Several suggestions on such matters that should not be included in the definition was also given in the Proposition, such as consultation on questions regarding subjects such as organization, tax and accounting, together with activities of audit review where the results are not intended to be used by a third party, for instance internal audit that is intended exclusively for the board of directors and the chief executive officer. Engagements that lie outside the auditor's professional activities, such as being a member of a company's board, or that would otherwise be of a private character, are also not included in the definition of audit (Proposition 2000/01:146, p. 39ff). The activities that are not included are considered, by us, as non-audit services.

The auditor is, due to his competence and knowledge about the company, in the perfect position of giving the client advises on their business. In the case whether an auditor could perform the audit as well as being a consultant for the same client, it is important to examine if the audited information might be impaired and its credibility, as well as if the objectivity and independence of the auditor could be impaired. As the auditor already has knowledge about the company, the client would probably save some costs if he would turn to the auditor for advices. The Swedish government has taken this into account when they decided not to implement prohibitions regarding the auditor and on services to their audit clients that are not audit activities, such as counselling (Proposition 2000/01:146, p. 52f). The law requires that an auditor should resign or decline from an audit assignment if there are any circumstances that may undermine the trust and confidence in the independence or objectivity of the auditor

(Revisorslag (2001:883), 25 §). But there is no information in RL whether an auditor is allowed to give their audit clients any other counselling than audit consultation. Since the law wants to ensure that auditors can complete the audit assignment and are free of interests that could conflict with this, an authorized or approved public accountant is only allowed to perform auditing activities. With authorisation from this regulation, RN can therefore prohibit an auditor from practicing an activity that is not considered to be auditing (Proposition 2000/01:146, p. 51f).

Audit regulatory bodies worldwide have set standards that auditors need to follow to make sure that independence is obtained while providing services to an audit client. It is of great significance that threats, as mentioned in section 3.3, to the auditor independence in mind and in appearance is detected, documented as well as minimized and, if it is possible, eliminated. Which types of measures that needs to be used is determined by the particular circumstances in each case. Nevertheless, essential steps that can be used in this progress is to have procedures for consultation of independence issues and to create a frequently documented and monitored control system within the audit firm and to have an organizational structure in the audit firm where any additional activity is separated from the audit activity (Proposition 2000/01:146, p. 100). The analysis model and the independence-rules are presented in RL 21 §. If there are any circumstances that could impair the trust in the auditor, such as the threats mentioned in section 3.3 (which are also mentioned in RL 21 §), the auditor should decline or resign from the assignment (Revisorslag (2001:883), 21 §). The analysis model's explicit requirement and procedures is stated as the following:

- Before each new audit assignment, the auditor should examine whether there exist any circumstances that may destabilize the confidence and trust in the auditors' independence and impartiality. The assumption is, if there is some evidence that such circumstances could exist, that it will disturb the trust and that the auditor therefore should decline or resign from the assignment. However, the auditor can accept the assignment if the assumption is neutralized by the auditor through two approaches:

- a) Controls in the specific case if there exist circumstances where there is no reason to question the impartiality or independence of the auditor.
- b) Identifies safeguards and carries out particular countermeasures which eliminate or reduce the threats whereby there will not be any reason to question the impartiality or independence of the auditor (Revisorslag (2001:883), 21 §).

4.2.3 *The new proposal in Sweden*

In the Swedish law today, there exists mandatory *key audit partner* rotation every seven years for auditors whom clients' company, or economic association, has transferable securities that are admitted to trading on a regulated market. The elected auditor of a company can participate in the audit again after a waiting period of two years (Aktiebolagslag (2005:551), chapter 9, 21 a §, and Lagen (1987:667) om ekonomiska föreningar, chapter 8, 8 a §).

There is an investigation performed by the Department, which is when an administrator performs an internal investigation of a proposal within the Department, and their findings and proposals to the Government can be found in a report that has been published in the Department's series (Ds) (Regeringskansliet, SOU, Ds och remissförfarandet). In one of the Department's investigation, Ds 2012:4 "Revision i finansiella företag", they propose that the current legislation should expand to include the assignment as senior auditor of a bank, a credit company, insurance or securities company, to maximum of seven consecutive years. The auditor can participate in the audit again after a waiting period of two years (Ds 2012:4, p. 18). The suggestion is given to complement the rules that exist for professional ethics, such as the conflict of interest-rules in chapter 9, 17 § ABL (2005:551) and "god revisorssed", in order to strengthen the auditors' independence where the auditor examines a financial company and to minimize the familiarity threat (Ds 2012:4, p. 20).

The Department has chosen to only recommend key audit partner rotation and not mandatory audit firm rotation. The reason for this is that the disadvantage of rotation and change of auditor is that specific knowledge of the audited company could be lost which could have a negative impact on the audit's efficiency and reliability. A newly appointed auditor must understand the company's specific situation, an often time-consuming process that is also more costly for the company being audited. But if the company has chosen a registered audit firm as an auditor, the rotation requirement applies for the senior auditor and the audit firm can thus remain in the assignment even after the auditor has been replaced. Any problems with a loss of knowledge at the time of auditor rotation may thus be regarded as limited (Ds 2012:4, p. 20). This proposal thereby suggest that audit firms, that only consist of one auditor, in fact, has to be a part of mandatory 'audit firm' rotation, since they are not allowed to participate in the assignment during the waiting period of two years. This could result in the possibility that mandatory audit firm rotation might be the next step in Sweden.

4.3 Italy and the Parmalat-scandal

Italy is relevant to consider when presenting mandatory audit firm rotation since they have had the rule as a legal requirement since 1974 (Cameran, Di Vincenzo and Merlotti, 2005, p. 7). The rule is assumed to protect and enhance auditors' independence, but despite the legal requirement for it in Italy, the Parmalat-scandal occurred. In 2003, the Italian company Parmalat Finanziaria SpA filed for bankruptcy protection and became quickly known as "Europe's Enron" since it was considered to be the largest financial collapse in Europe. One reason for the collapse was the Italian poor corporate governance system, which was characterized by an inactive takeover market, limited presence of institutional investors, weak accounting standards and low legal investor protection. Another reason was an agency problem with the conflicts of interest between the minority of shareholders and a controlling shareholder, who actually was Parmalat's founder, Chairman and CEO, where bonus-maximising for managers, occurred at the expense of the owners. These reason together with regulatory failure and accounting irregularities, among others, led to the bankruptcy of the company (Buchanan and Yang, 2005, p. 28f).

Between 1990 and 1999, Parmalat's lead auditor was Grant Thornton. Since Italy passed a new law that required companies to change auditors every nine years, Parmalat had to hire Deloitte. In these days, the accounting law in Italy allowed that the main auditor could rely on the work of a secondary auditor. This resulted in that Deloitte was not required to control the work performed by Grant Thornton and consequently was not responsible for its accuracy. However, Grant Thornton continued to audit some of Parmalat's subsidiaries between 1999 and 2002, and Parmalat had the discretion to decide which units that would be handle by Grant Thornton instead of Deloitte. The restriction, and the fact that Italian accounting law prohibited the provision to a client of both non-audit and audit services by an audit firm, did not ensure Grant Thornton's objectivity as a result of the only minor separation from Parmalat. The audit firm was merely the auditor for Parmalat, not its consultant, but for a mandatory audit firm rotation to be effective, it has to require complete detachment between the company and its long-term auditor (Buchanan and Yang, 2005, p. 45f).

Deloitte presented clean audit reports of the group accounts of Parmalat between 1999 and 2002, without verifying Grant Thornton's work independently. But rules, equivalent to the international auditing standards, regarding main and secondary auditors were introduced in Italy in 2003. These required the main auditor to re-consider the important findings of the

secondary auditors, which resulted in many raised questions and concerns about Parmalat's accounts on Deloitte's behalf. Parmalat's fraud was not prevented even though Italy's legislation is considered as tougher than SOX (2002), where rotation of audit partner is a requirement rather than audit firms (Buchanan and Yang, 2005, p. 45).

4.4 Table of the global context

	The selected country	About the country	Why we chose the country for our study	What we will present about the country	Has a mandatory audit firm rotation in their legislation
1	The United States	After scandals like Enron, the U.S. has enhanced their law and regulations.	Since the debate about mandatory audit firm rotation in Sweden is relative small we will seek information from the U.S. as well. The reason for this is that the U.S. is of great importance and influences the rest of the world with their choices in accounting and auditing.	The current legislation in the U.S., which protects the independence of auditors, will be presented. This in order to see how they have responded to financial as well as corporate scandals and to see how they have protected auditor's independence.	No.
2	Sweden	At the same time as the U.S. enhanced their law, the Swedish law was also enhanced.	The basic case country for our study is Sweden, as we will work as auditors here and we therefore want to know how the current legislation is and if a mandatory audit firm rotation will be introduced in the legislation in a near future.	The current Swedish legislation and the new proposal are presented.	No.
3	Italy	Italy has had a legal requirement for a mandatory audit firm rotation in their legislation since 1974.	This is presented due to its relevance for the subject and despite the legal requirement for it in Italy, the Parmalat-scandal still occurred.	We will present the Italian experiences to clarify the drawbacks of a mandatory audit firm rotation. We have chosen to present Italy and the Parmalat-scandal since this is the only European-country that has it as a legal requirement.	Yes.

5. Literature review

In this chapter we will describe how we have chosen the different articles that we have used and how reliable they are. Thereafter, we will discuss the articles by academics' and professional bodies' and their perceived advantages and disadvantages with mandatory audit firm rotation. Lastly, we present two tables over the used articles.

To strengthen auditor independence after the collapse of Enron and its auditors, Arthur Andersen, together with audits' quality improvements and decreasing the occurrence of audit failures, different mechanisms were considered by regulators in the world (Carrera et al, 2007, p. 673). In the study "Mandatory Rotation of Audit Firms" by FEE, Fédération des Experts-Comptables Européens, (2004), they pointed out that the implementation of a required mandatory audit firm rotation has usually been opposed by the auditing profession (FEE, 2004, p. 13). However, there is a risk that an auditor's objectivity and independence might be affected by a long-term relationship between the auditor and their audit client and thereby creating a familiarity threat that might be avoided by an implementation of mandatory audit firm rotation (FEE, 2004, p. 3 and 7). We therefore want to examine how the academic and professional articles in general perceive mandatory audit firm rotation and which are considered for and against it, and why.

5.1 The chosen articles and their reliability

We have tried to identify those academic and professional articles that we consider to represent the views of the academic and professional world in an acceptable manner. We have also tried to be critical in our approach of finding impartial and objective researchers, and if they were sufficiently reliable to serve as an example and be used as a basis. At the same time it has been difficult to find information on our specific topic and regarding the advantages and disadvantages of mandatory audit firm rotation in the world since the academic articles can be characterized by the authors' own opinions rather than reliable facts. This because it is such an unexplored phenomenon within research since there only are a few countries which have a legal requirement of mandatory audit firm rotation, and that it thereby does not exist much empirical evidence of why it should be positive versus negative to implement. We have excluded the opinions and comments on this subject expressed through the media in order to only present reliable facts.

We have found the different academic and professional articles by using various search terms such as “mandatory audit firm rotation”, “audit firm rotation” and “firm rotation”, on different search engines on the internet such as Google Scholar and Lund University’s search system for library materials, known as Summon. We have therefore chosen the various articles due to their relevance and to achieve a result that is represented by various countries in the world. For that reason, we have chosen academic articles about countries such as Spain, where the rule has been implemented and subsequently removed (Carrera et al, 2007, p. 672), and Italy, where the rule has been a requirement since 1974 (Cameran, Di Vincenzo and Merlotti, 2005, p. 7), and the United States, where they have investigated the potential effects of requiring the mandatory audit firm rotation and its relation with fraudulent reporting (Carcello and Nagy, 2004, p. 1f). The article from ICAEW is included because they are a very active professional body in United Kingdom within research and is considered as a world leader of the finance and accountancy profession (Institute of Chartered Accountants of England and Wales, Who we are). The FEE is based in Brussels and is also an active professional body that is considered as the voice of the European accountancy profession (Federation of European Accountants, About FEE – Introduction to FEE). The article from GAO represents the SOX and United States’ thoughts of the subject (The General Accounting Office, About GAO).

Most of the articles have been mentioned in each other, which gives credibility to the researchers and that they have great experience on the subject. The professional articles are considered with high credibility, for instances because they have been conducted by request of regulators, such as the GAO study (GAO, 2003, p. 2). These will also give credibility to those academic articles that have used the professional articles as a basis for their arguments. Some researchers only mentioned other academic articles to point out that they have investigated various independence issues, such as mandatory audit firm rotation and non-audit services, whereas other articles only have investigated one, such as the article “The Audit Firm Rotation Rule: A Review of the Literature” by Cameran, Di Vincenzo and Merlotti (2005). Researchers in other academic articles have used the work and results of other researchers in their own investigation. The article “Mandatory audit firm rotation in Spain: a policy that was never applied” by Carrera et al (2007) have for instance been used in several academic and professional articles as a practical experience where the rule did not work (Carrera et al, 2007, p. 672). Porter, Simon and Hatherly (2008) have also used some of the mentioned articles, such as FEE, ICAEW and GAO, for their view on the perceived advantages and disadvantages.

5.2 Academic articles for and against mandatory audit firm rotation

5.2.1 "Mandatory audit firm rotation in Spain: a policy that was never applied" (2007)

In regulatory debates after 2001, the case with Spain was used as an argument by, for instance, professional associations and regulators against mandatory audit firm rotation and as a practical experience where the rule did not work (Carrera et al, 2007, p. 672ff). The article "Mandatory audit firm rotation in Spain: a policy that was never applied" by Carrera et al (2007) is a quantitative study which analyze the implementation in 1988 of the audit firms' required mandatory rotation at least every nine years and the subsequent removal of it in the Spanish Audit Law in 1995 (Carrera et al, 2007, p. 672). They have conducted a historical analysis of articles by academics and professional bodies from different countries regarding auditors' independence and the advantages and disadvantages of mandatory audit firm rotation. It is also based on documents produced by the professional associations of auditors in Spain, congressional hearings and financial newspapers (Carrera et al, 2007, p. 671) to provide an analysis of what really happened, after the implementation of the requirement, in professional and parliamentary circles in Spain (Carrera et al, 2007, p. 689). The implementation was affected by Spain's membership in the EU, European Union, and different parties in the Parliament had different opinions, such as the rule's advantages that it would ensure auditors' independence and that it would avoid a greater concentration of work between few large auditing firms. But also the disadvantages were considered, such as that the related start-up cost with a new auditor was too high and not desirable and that the majority of the auditors were against such rule (Carrera et al, 2007, p. 677ff).

Carrera et al (2007) pointed out that the mandatory rotation of audit firms has been held to have a negative effect on the audit market structure and on the quality of auditors' work but that it never was enforced on Spanish auditors, meaning that the audit firms in practice did not have to rotate. This was because the regulators had confirmed that the rule of rotation did not work and could therefore not achieve its public policy's objectives. But, since the first rotation should have been performed first in 1997, Carrera et al (2007) consider that the mandatory rotation appears to have been a politicized process where the connection between Spanish professional audit practice and experiences with legislative changes seems to have been very loose (Carrera et al, 2007, p. 672). Thus, resulting in that the rule was removed due to political convenience influenced by pressures from the auditing profession and therefore Spain might not be the best practical experience as an argument against the rule (Carrera et al,

2007, p. 682f). After corporate scandals such as Enron, the audit firms' mandatory rotation has been suggested as an important way by which auditor independence could be enhanced, and thereby Spain considered re-establishing the mandatory rotation every twelve years for listed companies. The parties' arguments were that this would increase and ensuring auditor independence (Carrera et al, 2007, p. 684), but the professional auditing bodies rejected this proposal meaning that it would only generate distortions in the market. The president of KPMG in Spain, Mr. J. L. Pérez Rodríguez, commented the proposal as stated below:

“... with the exception of Italy, there is no compulsory audit firm rotation in any other country, and even there, after ten years using this system, different studies conclude that either groups of professionals leave the audit firm ... following their clients or audit firms agree to swap their clients. This is a clear signal that rotation is not efficient and it only causes market distortions. On the contrary, rotation of the audit partner and the gradual change of audit teams ... is something that many audit firms have been doing for years and it works” (Carrera et al, 2007, p. 687f).

The opposition parties instead proposed, in line with the EU's recommendations, rotation of audit partners and audit teams every seven years, which became the new law for supervised and listed companies as well as for companies with a turnover higher than €30 million (Carrera et al, 2007, p. 687f).

5.2.2 “The Audit Firm Rotation Rule: A Review of the Literature” (2005)

The article “The Audit Firm Rotation Rule: A Review of the Literature” by Cameran, Di Vincenzo and Merlotti (2005) is a quantitative study where the rule of mandatory audit firm rotation were reviewed. It was conducted through academic studies and reports by regulators or other representative bodies in 24 countries in order to contribute to the international debate about the requirement (Cameran, Di Vincenzo and Merlotti, 2005, p. 6ff). 26 reports by regulators or other bodies, with the most used topic of mandatory audit firm rotation in relation to auditor independence, were reviewed in this article (Cameran, Di Vincenzo and Merlotti, 2005, p. 10). The majority of the reports in the entire geographical region studied (USA, Europe, Universal and Other Area) were against audit firm rotation, in which four were

in favor of the advantages and thereby 22 were against them (Cameran, Di Vincenzo and Merlotti, 2005, p. 12ff). Three of the four reports in favor of the rule are also studies on the countries that have it as a legal requirement for at least some companies, for example for all listed companies in Italy (Cameran, Di Vincenzo and Merlotti, 2005, p. 14f).

As for the reports by regulators, the majority of the 33 academic studies reviewed by the researchers were against mandatory audit firm rotation (Cameran, Di Vincenzo and Merlotti, 2005, p. 4), as ten studies were in favor of it and 23 were against it (Cameran, Di Vincenzo and Merlotti, 2005, p. 47, figure 10). The researchers divided the advantages and disadvantages into four different topics: Audit firm rotation in relation with independence; audit quality; audit costs; audit market competition; and capital market reaction (Cameran, Di Vincenzo and Merlotti, 2005, p. 4). According to Cameran, Di Vincenzo and Merlotti (2005), some of the advantages, in the overall relation, mentioned in the 33 academic studies were:

- That the rule's effectiveness maintains the new, fresh view and the independence required to perform a good audit and to improve its quality by reducing the familiarity-threat.
- That audit firms will increase in numbers and thereby increasing the competition. This in turn decreases the audit price for the first year, but in the subsequent years the price rises which is called "low-balling".
- That it would decrease the occurrence of audit failures, amend the audits' quality and increase the auditors' perceived independence (Cameran, Di Vincenzo and Merlotti, 2005). An example of the last statement is that 67 out of 180 of auditors and 189 out of 300 of listed companies in Australia thought that the perceived independence as considered by third parties would be improved by the rule's implementation (Cameran, Di Vincenzo and Merlotti, 2005, p. 26f).

According to Cameran, Di Vincenzo and Merlotti (2005), some of the disadvantages, in the overall relation, mentioned in the 33 academic studies were:

- Due to the rule of audit firm rotation, the motivations for creating a reputation for honesty may be damaged in short-term engagements, which leads to that the independence could be impaired.

- That the motivation to invest in a specific industry for the auditors is reduced and the related audit costs were considered as too high due to the increase in dedicated time by the auditors.
- That in an engagement's first years, lawsuits, the audit failure risk and fraudulent financial reporting increases due to the rule.
- The opinion that a good audit is best performed after the development of cumulative and specific knowledge during the engagement by audit teams.
- To organize the acquisition of audit clients, the likelihood of collusion is not increased among audit firms by the rule (Cameran, Di Vincenzo and Merlotti, 2005).
- Another example from Australia is that most listed companies and auditors in Australia were against the rule due to their concern that the benefits were outweighed by the cost (Cameran, Di Vincenzo and Merlotti, 2005, p. 26f).

Cameran, Di Vincenzo and Merlotti (2005) concluded that, based on the findings in the professional and academic articles, the intended benefits are generally uncertain and that mandatory audit firm rotation is not supported by the majority, regardless of the advantages in the four different topics.

5.2.3 *“Audit firm tenure and fraudulent financial reporting” (2004)*

Carcello and Nagy's (2004) article “Audit firm tenure and fraudulent financial reporting” is a quantitative study and they reviewed 147 fraud observations from 1990 through 2001 to examine the link between audit firm tenure and fraudulent financial reporting. The researchers argue that regulators may have a great interest in mandatory audit firm rotation because of the suggestion that it would improve audit quality if the audit firms were rotating voluntarily (Carcello and Nagy, 2004, p. 2). But there are also regulators against the rule, such as Roderick M. Hills, a former SEC Chairman who stated:

“Forcing a change of auditors can only lower the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. To change every several years will simply create a merry-go-round of mediocrity” (Carcello and Nagy, 2004, p. 3).

Carcello and Nagy (2004) concluded that mandatory audit firm rotation could have adverse impact on audit quality and that it was more likely that fraudulent financial reporting would occur in the audit engagements' first three years due to the auditors' lack of knowledge about the client's company and industry. The study also showed that it was less likely of fraud in large companies and if it had been public for a longer time (Carcello and Nagy, 2004, p. 6ff and 18).

5.3 Professional bodies' articles for and against mandatory audit firm rotation

5.3.1 "Mandatory Rotation of Audit Firms" (2002)

The study "Mandatory Rotation of Audit Firms" by ICAEW (2002), the Institute of Chartered Accountants of England and Wales, is a quantitative study which focuses on the familiarity threat and the long-term relationship between the auditor and their audit client, and whether the implementation of mandatory rotation of audit firms could minimize the threat (ICAEW, 2002, p. 4). ICAEW is an organization for professional accountants around the world that provides leadership and insight to the global finance and accountancy profession (Institute of Chartered Accountants of England and Wales, Who we are). They are thus interested in safeguards that could minimize or eliminate threats to auditors' independence. ICAEW have conducted a review of current requirements, research by academics and publications by Governments. The article analyzed two academic studies, made by Arrunada and Paz-Ares in Spain (1995) and by SDA Universita Bocconi in Italy (2002) (ICAEW, 2002, p. 1), which were described as providing empirical evidence against mandatory audit firm rotation. The reason for this was because they acknowledged that such a rule would in the early years of the appointment, due to lack of knowledge about the client, have adverse impact on audit quality and would enforce additional costs on audit firms and companies (ICAEW, 2002, p.12 and 16ff). The researchers of the academic study by SDA Universita Bocconi in Italy (2002) did provide, as mentioned above, empirical evidence against mandatory audit firm rotation. However, their investigations also indicated that the rule was widely accepted by different actors in the Italian market. For instance, a requirement for a more frequent mandatory audit firm rotation was responded by 69 percent of the interviewed external auditors as having a positive impact on auditors' independence. The responses from the interviewees indicated that the rule's effect on audit costs would consequently either fall in price or not change (Carrera et al, 2007, p. 675).

The article from ICAEW summarizes the identified advantages derived from their research as:

(i) An improvement in audit quality due to the avoidance of over-familiarity with the client and its management and the opportunity for a fresh approach to the audit,

(ii) A better perception of auditor independence, and

(iii) The benefits of competition (ICAEW, 2002, p. 2).

The perceived disadvantages are recognized as:

(i) Additional start-up costs affecting both the auditor and client,

(ii) Adverse effects on the quality of the audit due to a lack of familiarity in the first and early years of the audit,

(iii) A lack of incentive if the audit is about to change hands and

(iv) The signals that may be given out currently when there is a change of auditor will be lost (ICAEW, 2002, p. 2f).

ICAEW concluded that, based on the findings in the professional and academic articles, the associated costs with mandatory audit firm rotation are unacceptably high and therefore the disadvantages outweigh the potential and intended benefits of the rotation (ICAEW, 2002, p. 2f).

5.3.2 “Mandatory Rotation of Audit Firms” (2004)

The study “Mandatory Rotation of Audit Firms” conducted by FEE (2004) is a quantitative study and reviewed what academics, professional bodies, governments and other regulators perceived as advantages and disadvantages with mandatory audit firm rotation (FEE, 2004, p. 4). FEE is an abbreviation for Fédération des Experts-Comptables Européens, and in English, the Federation of European Accountants. FEE works internationally and is a non-profit organization that represents the European accountancy profession and 45 associations of professional auditors and accountants from 33 European countries. FEE is also a member of IFAC, which make this study highly reliable (Federation of European Accountants, About FEE – Introduction to FEE).

The FEE study presents the main arguments, both advantages and disadvantages, from the most important, according to them, studies performed on this subject (FEE, 2004, p. 4). Some of the presented advantages were that the rule could be used to manage or minimize different threats to auditors' independence and objectivity, for instance prevent the close personal relationship between the auditor and the client's management in the familiarity threat as a safeguard, and thereby the auditing profession's long-term health will improve and a "fresh look" will be given to the audit (FEE, 2004, p. 8f). Another effect of mandatory audit firm rotation could be that there will be more competition in the audit market regarding the audit price, which could be positive for the users but considered as inappropriate since the audit is a "public interest" activity (FEE, 2004, p. 17f).

Some disadvantages were that the existing risk of audit failure would be higher during the first years of the audit work as an effect of that the important and cumulative knowledge, which has been acquired during the auditor-client relationship, would be lost when rotating and a new auditor's lack of knowledge could dramatically reduce audit quality. It would be more difficult for audit firms to develop and maintain their degree of specialization within various industry sectors, and the level of auditor competence would therefore be reduced (FEE, 2004, p. 11f and 18f). FEE reached the conclusion that the considered advantages with mandatory audit firm rotation were, without a doubt, outweighed by its severe negative impact on audit quality (FEE, 2004, p. 3). They consider it as an unnecessary step and that its main impact will be to increase the risk of audit failure and damage the auditing profession's reputation, which would not be something to strive for when restoring the public trust in financial reporting (FEE, 2004, p. 5). They instead recommended that threats to auditors' independence and objectivity could be mitigated by alternative means, such as that the audit firms' work could be supervised by an external oversight body and rotation of audit partners (FEE, 2004, p. 3).

5.3.3 "Public Accounting Firms – Required Study on the Potential Effect of Mandatory Audit Firm Rotation" (2003)

The SOX (2002) required the U.S. GAO, the General Accounting Office, to conduct a study of mandatory audit firm rotation and the potential effects of requiring it for registered public accounting firms (GAO, 2003, p. 2). GAO works for the Congress and is a nonpartisan, independent agency which provides fact-based, objective and fair information to the Congress

in order to support them in meeting its constitutional responsibilities (The General Accounting Office, About GAO), which make this study highly reliable. In 2003, the GAO conducted a study that is both quantitative and qualitative. They reviewed research studies, technical articles, other documents and publications regarding auditors' independence and audit quality associated with the length of the period with the same auditor, and the benefits and costs of mandatory audit firm rotation. The GAO surveyed 97 large public audit firms with at least 10 public clients registered with the SEC, 391 foreign companies registered with the SEC, 330 of the Fortune 1000 public companies and 450 other domestic companies and mutual funds. The chief financial officers and audit committee chairs in each of these three groups of public companies were asked to complete separate questionnaires to obtain their views of the issues associated with mandatory audit firm rotation. The GAO also held discussions with officials of other interested stakeholders to obtain their view of the associated issues, such as U.S. stock exchanges, the PCAOB, federal banking regulators, and the AICPA, the American Institute of Certified Public Accountants (GAO, 2003, p. 2ff). They also studied mandatory audit firm rotation in other countries to obtain information about their experiences with it. The participants, who had abandoned the requirement, gave the reasons that it was too costly, its lack of cost-effectiveness and that they already had achieved an increased competition in the market for audit services (GAO, 2003, p. 48).

The majority of the participants in the GAO's survey believed that the SOX's current requirements for auditors' independence, audit partner rotation, audit quality and other reforms will adequately achieve, when fully implemented, the intended benefits of mandatory audit firm rotation (GAO, 2003, p. 14). But as the majority of public companies prefer to solely use the big four (KPMG, PWC, Ernst and Young, and Deloitte) audit firms for audit services, they can then only chose between one or two audit firms because of the significance of industry-specific expertise and the SOX's requirements on auditor independence. This might, on the other hand, result in more audit firms specializing in further industry sectors thus leading to a number of bigger audit firms that are able to conduct the audit of a public company (GAO, 2003, p. 50).

Proponents of mandatory audit firm rotation believe that a longer period with the same auditor increases the risk that audit quality and auditors' independence ultimately may be adversely affected. They also believe that periodically changing auditors will bring a "fresh look" to the financial reporting of a company (GAO, 2003, p. 6 and 15). On the other hand, most of the

participants believe that changing audit firms, in the early years of the audit, increases the risk of an audit failure. The reason for this is that while a new auditor acquires the essential knowledge of a company and its financial reporting practices, the auditor might fail to detect a material financial reporting issue (GAO, 2003, p. 14). Some participants responded that the current requirement of audit partner rotation adequately achieves the intended “fresh look”. It may not be as effective as mandatory audit firm rotation, but it would be provided at a lower cost (GAO, 2003, p. 38). The GAO concluded that the costs associated with mandatory audit firm rotation, such as the loss of company-specific knowledge and the associated additional costs for both the public accounting firms and the public companies (GAO, 2003, p. 18 and 27), are expected to exceed the benefits and that there are more efficient ways to enhance audit quality and auditors’ independence. The GAO instead recommended that, given the provisions of SOX that are designed to strengthen auditors’ independence, the best course of action is for the SEC and the PCAOB to monitor the effectiveness of the SOX’s requirement before any further measures are introduced (GAO, 2003, p. 51).

5.4 Table of academic and professional articles

5.4.1 Table 1: The academic articles

	Author, Title Year, & Journals ABS ranking	Theoretical Approach	Data	Findings	Advantages	Disadvantages
1	Carrera et al (2007). Mandatory audit firm rotation in Spain: a policy that was never applied. Accounting, Auditing & Accountability Journal. ABS: 3.	Primarily based on previous research on mandatory audit firm rotation, documents by the professional associations of auditors in Spain, congressional hearings and financial newspapers.	Articles by academics and professional bodies from different countries have been used as data to conduct a historical analysis of them.	Mandatory audit firm rotation was never enforced on Spanish auditors and it appears to have been a politicized process . Many politicians were in favor of it, whereas the professional bodies strongly were against it .	+ It would increase and ensure auditor independence and avoiding a greater concentration between few large audit firms.	– Related start-up cost with a new auditor is too high and not desirable and that it would only generate distortions in the market.

2	<p>Cameran, Di Vincenzo and Merlotti (2005). The Audit Firm Rotation Rule: A Review of the Literature. ABS: Not listed in a journal. Yet included due to its relevance.</p>	<p>Primarily based on previous research on mandatory audit firm rotation.</p>	<p>Sample of 59 reports from 24 countries, whereby 26 reports by regulators or other bodies and 33 academic articles.</p>	<p>Intended benefits are generally uncertain and that mandatory audit firm rotation is not supported by the majority, 45 of 59, of the reports and articles, where only 14 were in favor of it.</p>	<p>+ It would maintain the new, fresh view and increase the auditors' perceived independence and improve the audit's quality by reducing the familiarity-threat. That audit firms will increase in numbers and thereby increasing the competition.</p>	<p>– It would reduce the motivation to invest in a specific industry for the auditors and the related audit costs are considered as too high. That in an engagement's first years, lawsuits, the audit failure risk and fraudulent financial reporting increases. The development of specific knowledge by the audit team would be lost.</p>
3	<p>Carcello and Nagy (2004). Audit firm tenure and fraudulent financial reporting. Auditing: A journal of practice & theory. ABS: 2.</p>	<p>Primarily based on previous research on mandatory audit firm rotation.</p>	<p>Sample of 147 fraud observations and over 68,000 non-fraud observations. Draw their own hypothesis based on articles by academics and professional bodies.</p>	<p>Indicate a higher incidence of fraudulent financial reporting in the early years of the audit due to the auditors' lack of knowledge about the client.</p>	<p>+ It would prevent very long-term relationship between the auditor and its client, the familiarity threat.</p>	<p>– It would lower the audit's quality and increase the costs. Specific knowledge developed by the audit team about the audit client would be lost.</p>

5.4.2 Table 2: The professional articles

	Author, Title & Year	Theoretical Approach	Data	Findings	Advantages	Disadvantages
1	ICAEW (2002) Mandatory Rotation of Audit Firms.	Primarily based on previous research on mandatory audit firm rotation and the current regulatory requirements in the UK.	Sample of 2 studies by academics, 2 reports by different Governments and various research and publication.	The associated costs with mandatory audit firm rotation are unacceptably high and therefore outweigh the intended benefits of the rotation.	+ An improvement in audit quality due to the avoidance of over-familiarity with the client and the opportunity for a fresh approach to the audit. It would have a positive impact on auditor independence.	– Additional start-up costs affecting both the auditor and client. Adverse effects on the quality of the audit due to a lack of familiarity and knowledge in the early years of the audit.
2	FEE study (2004). Mandatory Rotation of Audit Firms.	Primarily based on previous research on mandatory audit firm rotation and its impact on audit quality and on auditors' independence.	Sample of 14 articles by academics, professional bodies and regulators from different countries have been used as data to conduct an analysis of them.	The overwhelming majority of the reviewed studies conclude that the negative effects of audit firm rotation on the quality of the audit work by far outweigh its positive effects as a safeguard against various independence threats.	+ It would prevent the close personal relationship between the auditor and the client in the familiarity threat and thereby the auditing profession's long-term health will improve and a "fresh look" will be given to the audit.	– It would lead to a higher risk of audit failure during the audits' early years since the acquired knowledge would be lost and a new auditor's lack of knowledge could radically reduce audit quality. It would be more difficult for audit firms to maintain their degree of specialization within various industry sectors.

3	<p>GAO (2003). Public Accounting Firms – Required Study on the Potential Effect of Mandatory Audit Firm Rotation.</p>	<p>Primarily based on previous research on mandatory audit firm rotation and its impact on auditors' independence and audit quality associated with the length of the period with the same auditor.</p>	<p>Sample of 1268 participants and the use of separate questionnaires for the participants' chief financial officers and audit committee chairs and discussions held with other stakeholders. Technical articles, research studies, other documents and publications have been used as data.</p>	<p>The GAO concluded that the costs associated with a mandatory audit firm rotation are expected to exceed the benefits and that there are more efficient ways to enhance audit quality and auditors' independence.</p>	<p>+ It could result in more audit firms specializing in further industry sectors thus leading to a number of bigger audit firms that are able to conduct the audit of a public company. It would bring a "fresh look" to the audit and prevent that the audit quality and auditors' independence may be affected adversely.</p>	<p>– It would be too costly and lack cost-effectiveness. As the majority of public companies prefer to solely use the big four audit firms for audit services, they would then only be able to choose between one or two audit firms because of the significance of industry-specific expertise. The lack of knowledge would in the early years of the audit increase the risk of an audit failure.</p>
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6. The European Commission and mandatory audit firm rotation

In this chapter we will present information about the Green Paper and a summary of the responses on the Green Paper. Thereafter, we will present some chosen comments expressed on it by various stakeholders. Lastly, the final proposal will be presented.

6.1 Green Paper Audit policy: Lessons from the Crisis

The 13th October in 2010, the commissioner of internal markets and services Michel Barnier published a Green Paper about Audit policy. The main objective was to seek new ways of increasing the stability in the financial system. After the financial crises in 2008-2009, questions about how auditors could give companies clean audit reports when banks was making huge losses on advanced financial instruments were asked from various stakeholders. When the worst of the financial crisis was over, the EU Commission was keen to answer those questions which concerned the auditor's role and how auditors' independence could be strengthen to avoid a similar crisis in the future. It is stated in the Green Paper that audit firms must, like many other firms, actively manage their conflicts of interest. The difference is that law requires auditing and that auditors play a statutory role and acts as a safeguard for investors and other stakeholders. Auditor independence is therefore once again on the agenda. The result was a Green Paper that gives suggestions on how the audit market within the EU can be developed and legislated in the future. The Green Paper discusses how to increase the auditor independence and, in extension, also how to increase the financial systems stability. This thesis is most interested in what the suggestion is about the topic of mandatory audit rotation. With the background that many large companies have had the same audit firm for some decades; the EU Commission questioned how independent the audit firm is in reality. One way of confronting this question is to force the companies to rotate audit firm within a certain number of years. In the Directive on Statutory Audit (2006/43/EC), mandatory rotation is used but on "key audit staff". This is, however, not enough to decrease the familiarity threat according to the Green Paper. Based on that conclusion, the EU Commission suggests that mandatory audit firm rotation should be considered. To prevent the possibility that partners would change audit firms and take their clients with them, even partners should rotate as well. The EU Commission is aware that this suggestion has some drawbacks, such as loss of knowledge, but this argument is not strong enough in order to not examine the benefits and disadvantages of such a requirement. The Green Paper has also proposals to solve these drawbacks (Green Paper Audit policy: Lesson from the Crisis, 2010).

6.2 Summary of the response on the Green Paper regarding mandatory audit firm rotation

Since the purpose with a Green Paper is to invite interested parties, the EU Commission has released a document called “Summary of responses”. There was in total 688 responses, where 87 percent of these responses were from individual EU member states and two-thirds of the replies were from Germany, UK, France and Spain (Summary of responses Green Paper audit Policy: Lessons from the Crisis, 2011, p. 3).

6.2.1 Professional bodies, the big four, Mid Tier Firms and SMPs

The professional bodies were generally against mandatory audit firm rotation, but some respondents suggested limitations for engagements in PIEs. The big four is against limitations of continuous engagement of audit firms. They argue that studies have shown that mandatory rotations harms audit quality. Also the fact that the statutory audit directive is still being implemented with regard to key audit partner rotation, such ideas is premature according to the big four. Cost and impairment of audit quality was mid Tier firms and SMPs argument against mandatory audit firm rotation (Summary of responses Green Paper audit Policy: Lessons from the Crisis, 2011, p. 17).

6.2.2 Investors, Public Authorities and Academics

Investors had different views on mandatory audit firm rotation; with some against it and some in favor it. Some investors were against mandatory rotation but supported mandatory re-tendering after a determined period of years. Investor’s opinion was that more information is needed regarding aspects such as transparency from audit committees, on audit appointments and re-tendering. This also included more involvement of shareholders. The public authorities did in general not support the idea of mandatory audit firm rotation. They instead suggested that audit committees should be given more power in the decision when an entity should rotate their audit firm (Summary of responses Green Paper audit Policy: Lessons from the Crisis, 2011, p. 17).

There was some support from the academics regarding audit firm rotation. One given suggestion to minimize the loss of knowledge, was that the old and new audit firm could work together for a period to overlap the transition. In this way, there would not be a loss of

information or knowledge since there is a co-operation between the audit firms. The responding academics also meant that if all audit firms were submitted to the same discipline, there would not exist any losers in principle, as audit firms could find other clients. Rotation and fixed period appointment would, according to some academics, decrease any bias for the auditor to accommodate the management or shareholders to be re-elected. Another opinion was that when an auditor knows that a new audit firm would take over the audit of an entity, they therefore would revise the old audit firms' previous audits, since this would increase the motivation for the old auditor to make a proper audit. Another suggestion from the academics is stated as the following:

“Auditor appointment for a fixed 5-7 year period, with mandatory rotation of both audit firm and auditor after that period combined with limiting the dismissal of an auditor to cases of material reasons and with the approval of Courts will reinforce the independence of auditors.

This should at least be obtained for PIEs, such as banks and insurance companies”

(Summary of responses Green Paper audit Policy: Lessons from the Crisis, 2011, p. 18).

Finally, there were some comments drawn from theoretical and experimental research. Research has shown that mandatory audit firm rotation could be beneficial under specific circumstances, such as low cost when changing auditors, non competitive audit market and the reputation has limited effect on the auditor performance. There is also research that indicates that the engagement time does not matter so much in preventing audit failure, since this can occur under both short and long audit engagements. However, the audit failures are of different characteristics in the short and long audit engagements. Under a short audit period, the auditor is less likely to detect fraud and under longer periods, the auditor is more susceptible to forces that motivate management to manage earnings (Summary of responses Green Paper audit Policy: Lessons from the Crisis, 2011, p. 18).

6.3 The presentation and selection of the various comments

Our selection of the comments to the Green Paper is based on their relevance for the thesis. Comments from Sweden were natural to include since Sweden is our basic case country. Our selection of the Swedish comments aimed to capture as many different stakeholders as possible. The comment from Italy is of importance since Italy is the only country in Europe

that has mandatory audit firm rotation as a legal requirement today. The comments from UK are a mix between professional bodies and large corporations, which have been chosen since UK plays an important role in the debate as UK organizations are very devoted to influence decisions. We have also chosen to present some comments from audit committees in UK since they represent the companies. All major audit firms have commented on the Green Paper and our choice of both the big four and smaller audit firms are made with the intention to show a wide range of audit firms in matter of size and market share on PIEs. The United States is of great importance because they affect other parts of the world with their decisions. The PCAOB did, however, not have a comment on the proposal from the EU Commission, and when questioned, their answer was that their concern was the U.S.

6.3.1 Four different professional bodies and organizations in Sweden and their comments

FAR is a professional institute for authorized public accounts and approved public accounts and other qualified professionals in the accountancy Sweden (Far, Professional association for auditors and advisors). FAR do not support mandatory audit firm rotation. In their opinion it is well advised to wait and see the effects of IESBA's Code of Ethics for Professional Accountants. IESBA's suggestion is that it should not only be mandatory for the auditor to rotate, but that it should also include the key audit partner as well. FAR emphasizes different disadvantages, whereas one is the possible situation where the management and the audit firm rotate at the same time, which could have a negative impact on the financial statements. The right to vote for the auditor and audit firm should still remain for the shareholders, but FAR supports the idea of increasing the transparency of the appointment of the auditor. As an example, a practice could be established where the criteria for the appointment is described at the annual general meeting (FAR comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 13 and 20). The Swedish Shareholder Association is an independent organization for private individuals that invests in stocks, mutual funds or other financial instruments. The associations' objectives are to protect minority shareholders and to provide information and education for minority shareholders. The big fours market share is almost unacceptable according to the association. This would have to change so that other, smaller audit firm can grow and break the dominance of the big four. But the association does not believe that mandatory audit firm rotation; re-tendering or joint audits are the best alternatives for this. These suggestions will impose additional cost, which in the end will be carried by the

shareholder. The Swedish Shareholder Association is therefore against mandatory audit firm rotation (Swedish Shareholder Association comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 4). The Confederation of Swedish enterprise was formed in 2001 and is today the leading representative for almost all Swedish industries. Members are for example employer organizations and trade associations (Svenskt näringsliv, About us). This organization is against mandatory audit firm rotation since they believe that it will be expensive and that there is no evidence that it will increase the competition on the audit market. Sweden already has a rotation of auditors, which is sufficient to secure audit independence according to the Confederation. The result of their statement is that threats of familiarity only can arise between individuals and not between legal persons, and that audit firm rotation therefore not is needed in Sweden. The time aspect is also important because it takes time for a new audit firm to learn a big multinational corporation and its risks, which could lead to impairment of the audit quality rather than the opposite (Confederation of Swedish enterprise comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 6 and 8).

The Swedish corporate governance board's objective is to manage and administrate the Swedish Corporate Governance Code for listed companies in Sweden (Swedish Corporate Governance Board, About the board). This board is against mandatory audit firm rotation mainly because the learning curve for the new audit firm takes time before the audit will be effective. Appointing an auditor is best left to the shareholders and the owner lead nomination committee. The current law, which rotates the key audit partner each seven years, is enough according to the board (Swedish corporate governance board's comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 2).

6.3.2 One Italian organization and their comment

Assirevi-Associazione Italiana Revisori Contabili is private non-profit organization for Italian chartered accounts and has approximately 6000 members (Assirevi, about us). It is very interesting to see Assirevi opinion about mandatory audit firm rotation since Italy is the only country in Europe that has the requirement. Assirevi is not convinced that mandatory audit firm rotation is an adequate solution and, as many other respondents, Assirevi refers to the study made by Bocconi University, which also have been investigated in ICAEW's study "Mandatory Rotation of Audit Firms" (see further section 5.3.1 in our thesis). Some of the

effects of the rule have been that small audit firms has problem to take market shares and the big four market share in Italy is one of the biggest in Europe. According to Assirevi, mandatory audit partner rotation combined with rotation of key audit partners, as provided from IESBA's Code of Ethics would be a suitable protection against the familiarity threat. Assirevi also mentions the discussion of changing the directors and managers of the audited company and that it is appropriate that the shareholders are responsible for appointing the auditor (Assirevi's comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 7 and 11).

6.3.3 Five different professional bodies and organizations in the UK and their comments

ICAEW takes a standpoint against mandatory audit firm rotation since there is considerable empirical research, which shows that the rule is unlikely to have the desired impact on market concentration on the audit market. The reason for this is that rotation often happens between similar audit firms and that many countries that once had it as a legal requirement now have moved away from it. The removal is often explained by additional costs and concerns for the audit quality (ICAEW comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 13 and 36). ICAS, Institute of Chartered Accountants of Scotland, is a professional body that has over 19 000 members mainly from the UK and provides education, examination and regulation (ICAS, What we do). All members have achieved the internationally recognized Chartered Accountant qualification. ICAS does not support the Green Paper-suggestion on mandatory audit firm rotation. Their argument is that they do not believe that it would increase audit quality, and that there rather is a chance that the rule would reduce the quality. The cost of changing audit firm is also an argument against the rotation. ICAS thinks that the right to appoint the audit firm should be on the shareholders. The argument continues with that the Chief executive and financial director in UK listed companies are being replaced on a fairly frequent basis. This change in the clients' chiefs together with the fact that the key audit partner has to rotate every five years reduces the familiarity threat to some degree according to the ICAS. ICAS, however, sees a merit in requiring the audit committee to declare their policy on time-scale for re-tendering the audit. This also provides a way for the shareholders to challenge the time-scale when they think that it is appropriate. ICAS believe that a way of increasing the effectiveness of the annual review is that, in every five years, the audit committee performs a more detailed review of the auditor appointment. This review should

include the engagement with the shareholders to give them more information about the process so that when a tendering occurs, the shareholders could understand how the audit committee has reached its decisions (ICAS comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 14 and 18).

Admiral group plc. is an insurance company that owns 13 insurance companies in seven countries and has a market capitalization over £ 4 billion with a listing on the FTSE 100 (Admiral Group, Our Business). The response on the Green Paper was made by their audit committee, which states that the Green Paper restricts the company's ability to choose the best people for the audit. The audit committee does not share the view of the Green Paper that the market has failed to that extent that an intervention of this magnitude is necessary. The opinion of the audit committee is that if the Green Paper is implemented, there will be losses in quality and efficiency. There has also been changes in the UK corporate governance framework were measures are included to improve processes relating to audit independence and quality. The audit committee states that there should not be any limitations regarding the time of the audit firm engagements. According to them, the current rule for key audit partner rotation is sufficient and effective in maintaining long-term independence. One argument that the audit committee uses is that the reputational risk is too big for a large audit firm if the audit quality falls. It is therefore a small incentive for large audit firms to compromise on audit quality and their internal controls are strong (Admiral's comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 3f).

Standard life plc. is a company that provides bank services all over the world and is listed on the FTSE 100 (Standard Life plc, About Standard Life). Their audit and compliance committee does not believe that introducing mandatory rotation and regulatory provisions, which is suggested in the Green Paper, necessarily will have the intended effects. They state that a committee review process, which is fully disclosed in the governance report, is a fine way to counter a continues engagement. The committee also has a discussion each year if the audit firm should be re-appointed and they believe that the rotation of audit partner is sufficient and that a relationship between the auditor and its client is good. Their last arguments against the rule are that it will not add any shareholder value, that it will be time consuming and expensive (Standard life's comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 2f). Associated British Foods plc. is listed on FTSE 50 with operations all around the world. The chairman of their audit committee has written his

comments on the Green Paper and he argue that in a large, complex or geographically spread company, it takes years for the audit firm to become familiar with the risks and processes that an auditor needs to understand to perform an effective audit. This lack of knowledge and understanding of the company would increase the audit risk and also impose an unnecessary cost, disruption and an inefficient burden on companies. These suggestions will not lead to any significant advantage for the shareholders. In the end of the comments regarding audit firm rotation, the chairman says that rotation of the key audit partner is adequate (British Food's comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 3).

6.3.4 The big four Audit Firms

With almost 182 000 employees and offices in 150 countries, Deloitte is the largest audit and consultancy network in the world (Deloitte, About us, Annual report). Deloitte is against mandatory audit firm rotation and refer to that they have not found any evidence that support that an audit firm rotation will increase audit quality. According to Deloitte, the general shareholder meeting should keep the right to appoint the auditor, which includes the right to re-appoint the same auditor. They believe that the key audit partner rotation is adequate to address the familiarity threat and since this has been implemented in various member states, more time should be given to evaluate the results before more restrictions is added. If a company that exists in many countries must change audit firm for all their companies at the same time, it will be expensive. The scenario where different time-periods are used in different countries will be a problem since the company then has several audit firms that need to cooperate (Deloitte comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 12 and 18).

Ernst and Young have 152 000 employees and are represented all over the world (Ernst and Young, About us, Facts and figures). Ernst and Young are also against mandatory audit firm rotation and refer to same study that Assirevi refers to. According to Ernst and Young, shareholder should be free to appoint the audit firm when they feel that it is appropriate. Key audit partner rotation coupled with independence requirements and effective regulation oversight is better suited for the problems that the Green Paper discusses. Ernst and Young believe that the audit committee could be required to explain how they have assessed the audit quality made by the statutory auditor, and that they should give an explanation in this report

about why the company has re-tendered the audit. They, however, believe that this should not be forced upon companies by law or regulation (Ernst and Young comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 12 and 18).

KPMG have 145 000 employees in over 150 countries (KPMG, Who we are) and they are against mandatory audit firm rotation and they use the same argumentation as previous audit firms, but they bring up a situation that has not been discussed before. If a company goes through a period of major changes in the financial management, it is a disadvantage to change auditor under that period. Also a mandatory rotation could take place under circumstances where an auditor's knowledge and routine of company is vital for the future existents of the company. That is, according to KPMG, inconsistent with best practice corporate governance (KPMG comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 28 and 41).

PWC has offices in 158 countries and has 169 000 employees in total (PWC, About us). PWC thinks that the choice of audit firm should be made by the shareholders and, if that were the case, the audit market would be competitive and the audits must be delivered with high quality. According to PWC's experience of audit committees, they are very serious and approach the appointment decision every time it is taken. PWC also state that there only is a few companies which change audit firms voluntarily and that this should be seen as evidence that they already provide high audit quality and that companies does not want to change audit firm. PWC suggest formalizing the governance practice that many audit committees follow when they evaluate the effectiveness and competences of the auditors. The audit committee could do this with a certain interval and through a disclosure. This transparency makes the auditor keener to deliver good audit quality and is an innovation without the expense and disruption to the company of formal tendering (PWC comments on the Green Paper Audit policy: Lessons from the Crisis, 2010, p. 20 and 34).

6.3.5 Other audit firms

BDO is the fifth largest network for public accountings firms in the world. BDO has 48 800 employees in 135 countries (BDO, Home). BDO builds their arguments against mandatory audit firm rotation on the experiences from Italy, both from their own experiences and from

the academic studies. According to a study made by Bocconi University, mandatory audit firm rotation has over time resulted in a concentration of the audit market with disadvantages for other audit firms than the big four. BDO also has the opinion that the shareholders should keep the right to vote for an auditor after a recommendation from the audit committee. However, BDO supports the issue of guidance, which the regulators recommends, on a comply and explain basis, the periodic placement of the audit for tender by public companies. This could help the situation that exists in certain countries where the audit of large listed entities rarely comes out on tendering and this makes it hard to classify an audit market as competitive. BDO thinks that it is up to the companies themselves to decide how often they want to tender their audit. In the spirit of good corporate governance, BDO believes that the companies should be required to explain why they do not put out the audit on tendering (BDO comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 12 and 20).

Grant Thornton network is represented in over 100 countries and employs approximately 30 000 persons (Grant Thornton, About us, Grant Thornton International). Grant Thornton does not believe that audit tenure should be limited in time and they feel confidence in the checks and balances from the IESBA's Code of Ethics. Together with audit partner rotation every seven years, the current safeguards are sufficient according to Grant Thornton. Infrequent tendering would best be addressed by investor engagement and influence on the directors who makes the auditor appointment decision (Grant Thornton comments on EU Green Paper Audit Policy: Lessons from the Crisis, 2010, p. 16 and 27).

Mazars have 13 000 employees in 68 countries (Mazars, Home) and they are against mandatory audit firm rotation since they believe that the rotation of key audit partner is sufficient to ensure a fresh approach on a regular basis. In their comments, Mazars focus on regular and fair tendering by companies. When joint audit are coupled with regular and fair tendering, they can play an effective role in reducing systemic risk and promoting financial stability. This will later lead to a reduction of the high level of concentration in the audit market. Mazars lays much effort to explain what they think is a non-competitive audit market, such as that the tendering period is often short and not for all companies, although they have the right qualifications. When the audit committee and shareholder disclose their choice regarding their audit firm, there will be a more competitive audit market place. This will lead to new innovations, such as how to report audit findings, but also to more competitive fees. Mazars would expect regular tendering each ten-twelve years (Mazars comments on EU

Green Paper Audit Policy: Lessons from the Crisis, 2010, p. 17 and 30). SET revisionsbyrå AB, which has been a member of the Mazars network since 2010, is a medium-sized audit firm. Their comment to the Green Paper is more of a discussion where they meet FARs argumentation against mandatory audit firm rotation. SET believes that audit market concentration could decrease if the rule is implemented together with shared audit engagements. Overlapping periods, for instance four to five years, could solve the problem with consistency. An audit engagement for a firm could in total be eight to ten years (SET comments on EU Green Paper Audit Policy: Lessons from the Crisis, 2010, p. 1f).

6.3.6 The United States

AICPA, American Institute of CPAs, is the world's largest association that is representing the accounting profession with 377 000 members in 128 countries (AICPA, About the AICPA). AICPA thinks that IESBA's Code of Ethics is appropriate and that it has sufficient safeguards against the familiarity threat. AICPA lays their argumentation on four studies which all provide evidence that mandatory audit firm rotation does not increase audit quality. The most interesting study is also the most recent, COCO study "Fraudulent financial reporting: 1998-2007", which indicates that fraud firms are twice as likely to change auditors as non-fraud firms, between the last clean financial statements and the last fraudulent financial statements. AICPA therefore thinks that mandatory audit firm rotation could lead to higher costs and inefficiencies for companies and their shareholders. Safeguards with audit partner rotation and key audit partner is enough according to AICPA (AICPA comments on Green Paper Audit policy: Lessons from the Crisis, 2010, p. 5).

6.4 The final proposal for regulation

The final proposal regarding statutory audit of PIEs was published on the 30th of November 2011. Under the legal elements of the proposal, the advantages with a regulation are described. It states that a regulation is a suitable and proportionate legal instrument to ensure a high audit quality of PIEs. According to the proposal, direct applicability offers a greater legal certainty. With a regulation, the legislation would be applicable at the same date in all member states, which remove the problem with late implementation by member states. Harmonization would reach its highest degree since statutory audits will be carried out under substantially

identical rules in all member states (Final proposal, 2011/0359, p. 5). The proposal identifies the problem with independence as a result of non-existence of regulation regarding tendering of audit services and rotation. According to the proposal this has the effect that audit firms have lost one of its key ethos: professional skepticism. The proposal states, under the result of consultation with interested parties and impact assessment, which stricter rules for the appointment of auditors and mandatory rotation would contribute to a higher audit quality (Final proposal, 2011/0359, p. 4).

To address the familiarity threat, which comes from a low audit firm rotation among PIEs, the EU Commission introduces mandatory audit firm rotation and the details are found under subtitling 3.3.3 in the proposal. The proposal is that after a period of maximum six years, a mandatory audit firm rotation must take place. Under certain exceptional circumstances, this six-year period can be extended to eight years. In those cases where a PIE has appointed two statutory auditors or audit firms the maximum duration of that engagement is nine years, which can, under certain exceptional circumstances, be extended to twelve years. There will also be a cooling-off period before the audit firm can perform audit services for the same entity again. To ensure that the transition to the new auditor goes smooth, the old auditor must transfer relevant information to the new auditor (Final proposal, 2011/0359, p. 8).

Under the article 33, “Duration of the audit engagement”, the proposal about audit firm rotation is described more in detail. It is stated in paragraph one that a PIE shall appoint a statutory auditor or audit firm for an initial engagement, which shall not be shorter than two years. This engagement can be renewed only once by the PIE. The duration of these two engagements may not exceed a period of six years. On each six-year engagement, where two auditors or audit firms have been appointed, the maximum duration is nine years. The cooling-off period is clarified in paragraph two, which states that when the maximum duration of the engagement referred to in paragraph one is reached, the statutory auditor or audit firm or any members within its network within the Union, where applicable, shall not undertake a statutory audit of the PIE until a period of at least four years has elapsed (Final proposal, 2011/0359, p. 56). Paragraph five states that when a statutory auditor or an audit firm is replaced, the former statutory auditor or audit firm shall handover a file, which contains information that helps the new auditor or audit firm to understand the nature of the business and internal controls of the audited entity. The former auditor shall also grant access to the incoming statutory auditor or audit firm to the additional reports to the audit committee,

referred in Article 23, of previous years and to any information transmitted to competent authorities pursuant to Articles 25 and 27 (Final proposal, 2011/0359, p. 57).

As a control that this overlap of information occurs, the former audit firm or auditor shall be able to show for a competent authority that such information has been transferred to the incoming audit firm or auditor (Final proposal, 2011/0359, p. 57).

6.5 Table of the opinions from our selected comments

	Country of origin	Organization	Object with the organization	Arguments for or against mandatory audit firm rotation	Support mandatory audit firm rotation
1	World wide	The big four: - KMPG - PWC - Deloitte - Ernst and Young	The four largest audit firms in the world. Is driven by a profit interest	- Time to learn a company's structure - It is the shareholders right to elect auditor - Key audit partner rotation is sufficient - Rotation could be fatal in hard economic times	No.
2	World wide	- BDO - Grant Thornton - Mazars	Driven by profit-interest	- It is the shareholders right to elect auditor - Key audit partner rotation is sufficient - Rather see more guidance in tendering - A fair and regular tendering is preferable	No.
3	Sweden	- FAR - Confederation of Swedish enterprises - Swedish Shareholder Association - Swedish corporate governance board's	- Professional association for auditors and advisors - Represent employers and trade associations - Protect minority shareholders - Administrate the Swedish Corporate Governance Code	- Study the effects of IESBA code of ethics before mandatory audit firm rotation - Key audit partner and audit partner rotation is enough - Transparency in appointment of auditor is preferable - Mandatory audit firm rotation is too expensive for the companies	No.
4	Italy	- Assirevi	A private non-profit organization for Italian chartered accounts	- Hard for small audit firms to take market shares - The big fours market share is one of the highest in Europe - Rotation of key audit partner and audit partner is enough - It is the shareholders right to elect auditor	No.

5	UK	<ul style="list-style-type: none"> - ICAEW - ICAS - Admiral Group - Standard life Plc. - Associated British foods Plc. 	<ul style="list-style-type: none"> - Professional body, UK - Professional body, Scotland - Insurance company - Bank services - Food industry 	<ul style="list-style-type: none"> - The rotation will occur between similar audit firms - Losses in cost and efficiency - Audit committees is competent 	No.
6	U.S.	<ul style="list-style-type: none"> - AICPA 	<ul style="list-style-type: none"> - Professional association 	<ul style="list-style-type: none"> - IESBA code of ethics is sufficient - Not cost effective - Audit partner and key audit partner is enough 	No.
7	Investors , Public authorities and academics	<ul style="list-style-type: none"> - Europe 	<ul style="list-style-type: none"> - Financial institutions - Public authorities - Academics 	<ul style="list-style-type: none"> - Preferred more transparency in the tendering period - More power to the audit committee - Academic research is not coherent 	In general no.

7. Empirical study

In this chapter we will present the answers from the six interviews, where every individual answer will be presented together under each question.

In order to find out what audit firms thought about mandatory audit firm rotation, we have interviewed an auditor each from KPMG, PWC, Deloitte and BDO, which all were certified public accountants and partners at their firms, and they had international experience. Their clients were mainly larger corporations, which some of them were listed on the stock exchange. To broaden our perspective to the users of the financial statement, two interviews with investors from the financial institutions were performed. They had both long experience from credit analysis and corporate banking services. We have divided the answers into two sections, one for the auditors and one for the bankers. Since all our respondents expressed a deep desire to remain completely anonymous, no response will be represented by “Auditor and Investor A, B, C” and so on, so that their personal opinions and answers cannot be connected to the respective audit firm or financial institution. The reason for this is that personal opinions sometimes can be misinterpreted and give an inaccurate picture of the firm they represent. We have also put together fewer and more relevant questions to present our respondents answers more fluid and in order to link the answers to our research questions.

7.1 Interviews with four audit firms

7.1.1 How does your audit firm prepare for, and discuss, the EU proposal about mandatory audit firm rotation?

The topic mandatory audit firm rotation is not discussed on a daily basis in our respondents audit firms, but there has been some discussion on the partner meetings that our respondents have participated in. Most of the discussion from each individual audit firm was led from the international head office, which came with an official answer for the entire organization. Some of the audit firms had put together a special working group with the task to follow the development with mandatory audit firm rotation very carefully. One of these audit firms' respondent also stated that they are market leaders and that they will work as usual. Another auditor said that there would be some sort of co-operation between all the offices in their network when the final result will come. The last two auditors pointed out that there were many suggestions in the Green Paper and that they would have to wait and see which of these

suggestions that will become a reality for them. One of these auditors also mentioned that they try to affect the decision as much as they can and that they will adapt to the new rules if it becomes a reality. Most of the discussion about mandatory audit firm rotation in Sweden takes place in FAR. All of our respondents' firms are involved in FAR and stood behind FARs official comment to the Green Paper. One respondent stated that his audit firm could prepare themselves by ensuring that they have the right people and competence, if the right company would want their services.

7.1.2 Do you think the rule would affect auditors' independence?

One respondent meant that the connection between a perceived problem and its perceived reason is incorrect and that there is no conclusive evidence that there is a problem to begin with. Two respondents said that the current rules are sufficient and they argue that it takes time to build up an audit structure as well as learning all aspects of the clients' business and risks. This problem gets more complicated the bigger the client is. One auditor thought that mandatory audit firm rotation could increase auditors' independence in owner lead companies, but not in listed companies, while another respondent said that the rule probably could increase auditor independence since there will be a greater distance between the audit firm and the client. Nonetheless, the same respondent was skeptical to the suggested period of six-seven years since he believed that this time was too short to learn the client's risks. He referred to a similar discussion in the U.S. where they instead talk about ten years, and he also believed that it could be a good idea to increase the group that must rotate to include managers as well. One auditor stated the following:

“Today we already have a mandatory key audit partner rotation and there are also a ten-fifteen percent of changes in the audit team each year. This creates a good balance between new eyes and continuity.”

7.1.3 Which advantages do you consider that mandatory audit firm rotation has?

All respondents said that they think that it sometimes is good with new eyes and a different approach. One respondent mentioned that a new auditor take a lot of time to learn the new client and therefore also turns many stones that possibly has not been turned on for a couple

of years. The same respondent also saw that the reputation of the accounting profession could be improved with mandatory audit firm rotation as a result of a separation between the advisory and audit services. One respondent agreed that it occasionally is good to change a supplier of services, but that if this change should be mandatory is uncertain. The same respondent stated that it is the shareholders right to elect the auditor, and other respondents shared this opinion.

7.1.4 Which are the disadvantages with mandatory audit firm rotation?

The loss of knowledge, information, company history and continuity are disadvantages that were mentioned by our respondents. According to one respondent, it could take two-three years before the new audit firm is equally effective as the previous one. If you change audit firm every sixth year, there will be three-four years left with a good audit. There could also be a price pressure since it takes a lot of time to learn a new company and there could be a situation where the audit firm must do more work for less audit fees, which could have the consequence that the audit quality decreases. One respondent had a theory how the mandatory audit firm rotation could decrease the choices for companies. For instance, if an audit firm does a lot of advisory for a company, there could be a conflict of interest so that they cannot perform an audit or would not be interested to perform an audit since they earn more revenue on their advisory services. The consequences are limited choices for a large corporation and when auditing a multinational corporation in some countries, the big four could in reality be “the big three“ and or even “the big two”, which reduces the choices once again.

Increased costs for the clients was mentioned by three of the respondents, and one of them said that under the first year of an audit, they spend 30-40 percent more time on an audit since there is a lot of knowledge to gather. The clients would in the end pay this increased time. Another respondent had a similar argument and stated that the large investments in the beginning of an audit relationship are very costly. The estimate of an engagement is costly and much time is spent on building an understanding for the company and an audit structure, which in some cases could extend over numerous countries. Some of these costs are hard to charge the client for and the audit firm must therefore consider these costs as sunk costs. They argue that there would be an increased workload for the audit firm and the client since the new firm must ask questions and ask for audit evidence that the old audit firm did not have to ask for. The client must once again go through this procedure, which increases their workload.

Another respondent were concerned about the risk of fewer added values for the client when being audited by a mandatory audit firm.

All our respondents were also against the idea that mandatory audit firm rotation could increase audit quality. There were a broad variety of arguments and one respondent build his argument on that in some audit engagements, the audit teams could consist of hundreds of people. These people have learned the company in question and if they are replaced every sixth year, their knowledge will be lost, which is a waste of resources. The same respondent stated that the current key audit partner rotation and the fact that there also is a ten-fifteen percent of changes in the audit teams each year, already creates a good balance between new eyes and continuity. Another respondent meant that if you know that a rotation will occur, it will be harder to be motivated to make certain larger audit procedures one year that will give you advantages in the following year's audits. There is a risk that audit firm do not want to take on that cost since it will not gain their audit firm. One respondent referred to research that showed that the major mistakes in an audit occurs during the two first years of an audit engagement. The reason for this is because it takes time to get to know a new client and their specific risks. There is very little time to learn about the company and their specific risks under the first year. The risk for lack of focus under the last year was raised be one respondent because the lack of commitment and focus could decrease when you know that you will be replaced no matter what.

All our respondents believed that entity-specific knowledge could be lost. One respondent stated that transmission of information will not happen by itself and that it therefore is a large risk that information would be lost. There is a responsibility for the new audit firm to ask for information and show that they have the right competence for the new engagement. Another respondent said that there would always be a risk that information will be lost and stated the following:

“We will never get first-hand information when we take over a new company, but we always try to catch up the most essential discussions in the company.”

The same respondent also said that there is no other way, then what is done to today, to decrease the loss of information. It is unthinkable that you will be allowed to download each other's files, but he thought that there probably would be a deeper discussion when the

exchange takes place between the new and the old audit firm. Another respondent stated that there is no doubt that valued information will be lost and that, when an auditor audits a new firm, it takes time before you learn the informal levels and which people that could provide certain information. There is also an increased risk when the auditor does not know the people on the clients' company. The same respondent also gave the hypothesis that auditors might change audit firms so that they could remain as the auditor for the same client, but for another firm. One of the auditors responded that there could be improvements to decrease the loss of information. He said that it does not exist any transparency between the audit firms in Sweden today and when you take over an audit client, the only way to acquire information is to interview the old auditor. In other countries, they are much better to share information between audit firms and that maybe this should be the system in Sweden as well. One respondent had talked with some Italian colleagues and got the impression that they do not like it. The same respondent stated the following:

“If we go to the extreme and become very limited in what we as auditor is allowed to do, I believe that the audit industry will lose competence. We are not an extension of the tax authorities or the police; we are a business partner for our clients”.

7.1.5 Do you think that the rule would increase or decrease audit failures?

All of our respondents think that the numbers of audit failures will remain on the same level as they are today. As one respondent stated:

“Nothing is indicating that mandatory audit firm rotation will decrease audit failures. There are some incorrect assumptions in the EU proposal that the lack of auditor independence was one of the reasons for the financial crisis in 2008. I do not believe that you could blame the audit profession for crises. There are other variables that are more vital in creating financial crisis.”

Another respondent do not believe that a 100 percent security level could be reached with regulation and that there always is a risk that people will go around the law in ways that is hard to find out. One way is to control the auditor's own work by internal control where an auditor, which is not related to the case, goes through the case and see if he would do the same evaluations as the auditors working with the case have done. The same respondent adds

that auditors are not as close with their clients as the commission seems to think because there is a professional relationship between the client and its audit firm. One respondent said that the big audit failures could be reduced because of mandatory audit firm rotation, but that there, on the other hand, is an increased risk that restatements would increase instead because of mistakes that an audit firm does because the firm is new. Another auditor stated the following:

“It depends on if you believe that the most mistakes occur in the beginning of an audit engagement. But my answer would still be that it would not increase audit failure, since the former audit firm will make sure that they have made a proper investigation and explained it for the new firm. The old firm does this to avoid that problems could occur in the future and they also want to make sure that the new firm cannot find any mistakes from previous years”.

7.1.6 Do you think that various threats, for example the familiarity threat, against auditor independence would be reduced or enhanced by the rule?

Two of our respondents thought that the familiarity threat would not be affected by mandatory audit firm rotation. One answered that they try to have an absolute professional relationship with their clients. The same respondent said that there of course are people that are board members in many companies that you as an auditor will come in contact with. But he had hard to see that these people would recommend the same auditor all the time. The other respondent did not think that the familiarly threat would be reduced and stated the following:

“Today we have mandatory rotation on key audit partner, we have internal control to secure our independence and audit quality. Then we have Supervisory Board of Public Accountants that controls the auditors’ work. Then the Stockholm Stock exchange has controls on the annual reports. So there is control of auditor independence and audit quality. My opinion is that what we have today is enough”.

One argument, acknowledgment by one respondent, to decrease the familiarity threat is that the close friendship would decrease. But he also stated that it is enough to change the personnel within the audit team and that the clients have their own corporate rules to follow, so they are also limited in their behavior.

7.1.7 How do you believe the rule would affect your audit firm and your clients?

There were some differences between the answers depending on how large market share they had on the listed companies. One respondent took Brazil as an example where the market shares were stabilized after a period of time and stated that it is up to the free market to decide in the end. Another auditor believed that it would affect all audit firms, but he did not think that they would lose much in revenue. He also stated that they would not have the time to build up the same audit structure and that there would be a lack of support for the companies by the stakeholders if they change audit firm, and that clients therefore do not like to change auditors. A third respondent thought that mandatory audit firm rotation could be a benefit for his organization in Sweden, but that it would be negative for the global organization when it comes to the audit service. One auditor was not sure of the effects for their audit firm since their share of public traded companies is very small. He also said that not all listed companies are of their interest and that the scenario with mandatory audit firm rotation would be much worse for some of the big four.

Two of the respondents had a discussion about the increased workload for the client and increased cost was also mentioned by one of them. One respondent argued that a long relationship with the auditor is often an advantage and that the connection would be lost. He also mentioned that the companies' personnel change positions within the organization and that the auditor in these situations could stand for stability and knowledge, for example about previous accounting decisions. One respondent talked about the scenario where there is a separation between audit and advisory services, where the company has an auditor which only performs the audit and where the advisory services is carried out by another audit firm. The client will have a longer relationship with the firm that provides the audit services since the auditor will be replaced after a period of six years. The client will probably choose the best audit firm as a service provider as this firm would not have to be replaced.

7.1.8 What is your suggestion to increase auditors' independence?

Our respondents had many suggestions, whereas one respondent talked about the importance to have robust internal controls and another suggestion was to increase the auditors' reporting obligations. This respondent meant that there is a lack of understanding among shareholders and other stakeholders what an auditor in reality does and that a more detailed audit report

could be a way of reducing this lack of understanding. Another respondent said that there already is a lot done today, for instance rotation of key audit partners and there are audit committees. There are also a great deal of rules which control what an auditor is allowed, or not allowed, to do to become and stay independent, and since auditor independence is not a new problem, there are guidelines and extensive internal controls as well as education in the subject according to one respondent. The respondent gave examples of internal controls, such as control of auditor investments and when something is prepared for a client, the auditor needs to ask on an international level if it is against previous work that their organization has performed for the same client. One respondent's opinion was to expand the key audit partner rotation to include managers as well, to ensure auditors' independence. Another suggestion was to decrease auditor's possibilities to give advisory services. This respondent had clients in the U.S., where the distinction between audit and advisory services is much clearer compared to Sweden, and he thought that the development in Sweden might proceed towards that as well. The same respondents' experience from the U.S. is that audit committees are a good way to create another inspection of control. One auditor thought that the rules that exist today are sufficient, but that the Supervisory Board of Public Accountants perhaps could be harder in their supervision and that audit committees are a good idea when they are efficient in their work, which they often are. Another way could be to increase the regulation or guidelines for audit committees. Another respondent said that it all comes down to the people in the end. The individual auditor must have integrity and be able to say what he thinks to the client to claim the independence.

7.2 Interviews with two investors in the financial institutions

7.2.1 How do you use the financial statements and of what importance are they to your work?

Both our respondents say that financial statements are important and have a central role in their work. One respondent said that it is basic and very important. He believed that the annual reports and financial statements is the best source of information and that it sometimes is the only financial information that they as bankers obtain from the companies. The other respondent gives more concrete example of what financial statements mean for his work with the following statement:

”Financial statements are of great importance and constitute the backbone in our credit analysis work. The credit worthiness of a borrower, in other words, rating and financial ratios, is to a large extent determined by information contained in the audited financial statements”.

One respondent said that the audited annual reports are foremost a tool to determine the level of credit risk and credit worthiness related to a specific borrower. The credit risk is then used, amongst others, to determine the appropriate pricing for various bank products, such as loans, derivatives, strategic planning of the credit portfolio and equity allocation of the bank. There could also exist a formal legal requirement to evaluate the financial statements of various borrowers on a recurring basis in order for banks and financial institutions to be able to conduct business at all. The second respondent stated that the financial statements are used to study the balance sheet, the income statement, the cash flow and if the revenue is good enough. The income statement can contain lump sum payments, which creates a picture of the management. The balance sheet has become more important over time, for example because of the interest in the level of equity and goodwill.

7.2.2 Is your industry aware of the problem with auditor independence and the effect it could have on audit quality? Have you heard about the EU proposal about audit firm rotation?

Both our respondents said that the discussion about auditor independence is a matter that they do not discuss on a daily basis. One respondent specified that the majority of their borrowers are audited by large established audit companies (the big four) and that the bank therefore solely relies on their declared independence. He also mentioned that he had heard about the EU proposal and he knew that there already were some countries that had this system. The other respondent had heard very little about the EU proposal before he prepared for the interview and stated that they are aware of the problem but that they do not pay so much attention to it, and that a discussion about it rather comes up when corporate scandals happen, such as Enron.

7.2.3 How does financial institutions deal with audit problems and do you think that an audit firm rotation would affect audit quality?

One respondent talked about how banks have severe difficulties to protect themselves from biased auditing or, even in worst case, fraud. On the other hand, he thought that the increased focus on the audit practice, as a consequence to various scandals, have overall improved audit quality. But he also stressed the fact that banks, or other parties relying on audited financial information, will never be able to completely eliminate poor or even fraudulent auditing. The other respondent stated that the financial institutions does not have any guidelines of managing auditors' independence and that the industry has not dealt with the problem. The same respondent also mentions the risk of losing clients because the bank starts to ask more questions compared to other banks.

One banker thought that the audit quality would be higher whereas the other one said that the quality of the audit would be unchanged. One argument by our respondent in favor of audit firm rotation is that it would be beneficial to get "new" attention on the company in question, since most established audit firms have long experience, are highly specialized and professional. As a counterargument, to the argument that mandatory audit firm rotation would be expensive for the client since the new audit firm must analyze the client's organization and its risks, one respondent mean that after seven years, it is time to make this analyze anyway. The reason for this is that much happens in a period of seven years for big companies. One respondent also mention the problem with loss of information and knowledge.

7.2.4 Have you ever doubted the audit quality in the annual reports that you have worked with and how did this affect your decision?

Both our respondents said that the audit quality in general is good. One respondent stated that there could be a difference between larger corporations that are audited by big established audit firms, but that the quality of these financial accounts typically is of good quality. There could, however, sometimes be some minor mistakes. He also mentioned that the quality is more questionable in accounts from smaller companies that are located in other countries with different audit praxis and culture, but that this is an exception in his institution.

One respondent said that they work in a competitive industry and that they could not afford to say no to good deals. The other respondent stated once again that they generally rely on the

audited accounts and whether or not there are any qualifications in the audit report. If they believe that there is any reason to suspect poor auditing quality, this would be something that they would take into account in the valuation of the borrower's credit worthiness. He also mentioned that it always is their privilege to discuss any credit related concerns with the borrower, for instance how the auditing was conducted, if they felt uncomfortable with the result.

7.2.5 As a user of the annual reports, would you have a higher confidence in the reports if the audit firm rotation had been mandatory? Would the credibility be higher?

Both our respondents thought that an audit firm rotation could increase the confidence for the financial statements. One of them said that he believed that the receivers of the financial information would benefit from audit firm rotation. The other respondent thought that it would increase the audit quality and he stated the following:

"All business relations are to some extent personal between people. If you for the seventh year in a row shall perform an audit for the same company and persons, it is very hard to be objective and point out faults."

Our respondents gave two different answers regarding a higher credibility; whereas one of the bankers' opinions was that an audit firm rotation would increase the already rather high, creditability to some extent. The other respondent thought that he would have the same confidence for the annual reports since he believe that they are good and that they do not have many other inputs to work with.

7.2.6 Do you think that the rule could prevent future financial crisis and corporate scandals?

Our respondents also had two different opinions regarding this question. One stated that an audit firm rotation could prevent future crisis as well as scandals, and his argument was that the audit firms still have the Enron scandal, amongst others, and the collapse of the audit firm Arthur Andersen fresh in mind. If any inconsistency or biased accounting were revealed, this would be devastating for any audit firm, since they build much of their creditability and

reputation on trust. The other one said that the risk for crisis and scandals would be unchanged as long the audit firm performs advisory and audit services for the same company.

7.2.7 What suggestions do you as a user of the annual reports have to increase auditor independence?

One respondent used lawyers as an example and said that they are not allowed to take certain cases if there would be a conflict of interests, and he wondered why this could not also include audit firms. Separating the advisory and audit services was also one of his suggestions. The other respondent stated the following:

“The audit industry is already today rigorously controlled by various instances to ensure high audit quality. I must say that I am rather satisfied with the accounting standards of today and have little to add in that respect”.

8. Analysis

In this chapter we discuss the results from our empirical study, which have been performed through six interviews, against the literature presented in the chapter of theory, the global context-chapter, the comments to the Green Paper and the literature review-articles.

8.1 Analysis

In order to answer our research questions, we have chosen to divide the analysis into sub-headings by the subject of the mentioned advantages and disadvantages in the literature review-articles, the interviews and in the comments to the Green Paper, which is related to the sub-question "What advantages and disadvantages are perceived for mandatory audit firm rotation?". This has been done to illuminate and highlight the advantages and disadvantages that have emerged through this thesis and to have a more interesting analysis. The mentioned advantages and disadvantages were concerning auditors' independence, audit quality, familiarity threat, the loss of knowledge, new fresh look, the associated costs and audit failure. The discussion of our four sub-questions and our main research question will be analyzed in the different sub-headings and the analysis will end with a discussion regarding our main research question.

8.2 The auditors' independence

Our review of the academic and professional articles showed that the arguments for and against mandatory audit firm rotation generally concerned auditor independence, audit quality and audit costs. The main reason for an introduction of the rule has been argued within the reviewed articles as to improve auditor independence and objectivity. Some articles, like ICAEW, assume that long-term relationships between the auditor and its audit client can become too comfortable, with the auditors identifying too closely with the client's management and therefore losing their professional skepticism (ICAEW, 2002, p.11). It is therefore important that the auditor is independent and is perceived to be independent by a third-party and society, as discussed in section 3.1 the role of the auditor (Porter, Simon and Hatherly, 2008, p. 65). A too long-term audit relationship is often mentioned as one of the reasons to why an auditor may not act according to the independence-rules. Even RL statutes, through the analysis-model mentioned in section 4.2.2, that the friendship between the auditor

and the client is classified as a circumstance that could threaten the auditors' independence (Prop. 2000/01: 146 p. 102). This is also mentioned in IFAC's Handbook, mentioned in section 3.3, as the familiarity threat (IFAC, 2010, p. 12). However, one of our interviewed auditors responded that introducing mandatory audit firm rotation would not increase auditors' independence. This since the connection between a perceived problem and its perceived reason is incorrect. He meant that there is no conclusive evidence that there is a problem to begin with. This is consistent with the experiences from Italy, as mentioned in section 4.3, which reveals that a legal requirement for a mandatory audit firm rotation might not work as a safeguard for auditors' independence. Already in 1974, Italy adapted to the rule and introduced it as they assumed that it would enhance and protect the independence (Cameran, Di Vincenzo and Merlotti, 2005, p. 7). Even though the Parmalat-scandal occurred due to several reasons (See section 4.3), the auditors were given a lot of the blame. One reason for this might be the Italian accounting law of the time, which included that the main auditor was allowed to rely on the work of a secondary auditor. New rules regarding main and secondary auditors, which were equivalent to the international auditing standards, were introduced in Italy in 2003. One reason for this was to protect themselves from financial scandals as well as to protect auditors' independence and as these rules required the main auditor to re-consider the secondary auditors significant findings, Parmalat's accounts on Deloitte's behalf was questioned and many concerns was raised (Buchanan and Yang, 2005, p. 45f).

The topic mandatory audit firm rotation is not a subject that is discussed on a daily basis at our interviewed audit firms, but some have assign a special working group with the task to follow the development with mandatory audit firm rotation and to follow FARs discussion about the rule in Sweden. All our respondents audit firms are involved in FAR and stood behind FARs official comment to the Green Paper. Nevertheless, it is unclear whether or not the current rules of independence and the analysis-model in RL 21 § in Sweden is enough to secure auditors' independence. This could consequently be the reason for the new proposal in Sweden, where the Department has chosen to expand the current legislation regarding key *audit partner* rotation (Ds 2012:4, p. 18. See section 4.2.3). On the other hand, the overall opinion of the interviewed auditors was that the current rules are sufficient since they already have guidelines as well as education in the subject and that mandatory audit firm rotation is *not* necessary. But compared to the regulations in the U.S., the Swedish auditors are not as regulated as the auditors in the U.S. regarding non-audit services. SOX made eight rules

regarding non-audit services into law in 2001 to protect auditor independence from impairments caused by the provision of the non-audit services (Lindberg and Beck, 2004). The reason for this was that the Enron collapse in 2001 had a major impact on auditing regulations in the U.S. and in order to restore the public trust in the audit process, more regulation and severe penalties was imposed to protect from fraudulent behaviour in the financial markets. SEC has the opinion that if a non-audit relationship between an audit client and their auditor expands without regulation, the result of this could affect the user's reliance of the financial statement as well as on the objectivity of the auditor (SEC, 2001, Part III, C, paragraph 1). The reason for this opinion might be that Enron had a close relationship with its audit firm Arthur Andersen and due to the absence of a required level of auditor independence, also Arthur Andersen collapsed in 2002 since they failed to conduct proper audits of Enron's financial statements (Porter, Simon and Hatherly, 2008, p. 45ff). Nonetheless, more audit regulation might not be the way to restore the public's trust and Pott, Moch and Watrin believe that it only is an implied way of enhancing the failed audit function. However, they do believe that a combination of multiple requirements could maintain auditors' independence and minimize or eliminate the existence of several threats to the independence (Pott, Moch and Watrin, 2009, p. 209). There is no equivalence to SOX's eight rules regarding non-audit services in the Swedish law (See chapter four). However, the Swedish Proposition 2000/01:146 have *highlighted the significance* of the society's trust in the auditor and that it is important that it does not exist any circumstances which might make the surroundings question the ability of the auditor to be objective, inter alia non-audit services and personal relationships (Proposition 2000/01:146, p. 57). This was also made into law in 2001, which states that auditors in Sweden are entitled to exercise audit activities, but not any other activities which would disrupt the trust for the auditor (Revisorslag (2001:883), 25 §). The reason for that there is no equivalence to SOX's rules in the Swedish law is that the Swedish government has taken into account the fact that a company's auditor already has knowledge about the organisation and that the client probably would save some costs if he would turn to the auditor for advices on their business. The Swedish government therefore decided not to implement prohibitions regarding the auditor and on services to their audit clients that are not audit activities (Proposition 2000/01:146, p. 52f). One banker believes that the audit industry already is strictly controlled by various instances to ensure audit quality, and one auditor stated the following:

“Today we have mandatory rotation on key audit partner, we have internal control to secure our independence and audit quality. Then we have Supervisory Board of Public Accountants that controls the auditors’ work. Then the Stockholm Stock exchange has controls on the annual reports. So there is control of auditor independence and audit quality. My opinion is that what we have today is enough”.

Their reason for this was that it takes time to build up an audit structure and to learn all aspects of the client’s business and its risks. This is a problem that gets more complicated the bigger the clients’ company gets. Nevertheless, one auditor responded that mandatory audit firm rotation probably could increase auditors’ independence since there would be a greater distance between the audit firm and its client, but that the time is too short to learn the client’s risks. Another auditor thought that the rule perhaps could enhance the reputation of the auditor profession because of the separation of advisory service from the audit service. One auditor suggested that auditors’ independence could be enhanced if the requirement for auditors’ reporting obligations would be increased. He meant that most stakeholders have a lack of understanding of what an auditor in reality does and that a more detailed audit report might act as a safeguard for the auditor to reduce the misunderstanding. Another auditor believed that the independence could be enhanced if the possibilities for the auditor to give advisory services were limited. He referred to his experiences from the system in the U.S. where the distinction between advisory and audit services is much clearer compared to the Swedish legislation, as mentioned above (see chapter four for the rules in U.S. versus Sweden). This is also supported by one of the bankers, whereas one auditor assumes that this separation would lead to a longer relationship between the client and the audit firm that provides the advisory services than with the audit firm that performs the audit, since it will be replaced after a period of six years. There is a significant risk that the auditor becomes less critical in the audit review if there is no separation between the audit and advisory services. The reason for this is if the fees from the non-audit services have a strong connection to an audit firm’s turnover (see the self-interest threat in section 3.3). There could also be a risk for an auditor to review his own work performed during the advisory service (Porter, Simon and Hatherly, 2008, p. 127. See the self-review threat in section 3.3). One possible outcome could be that the audit firm chooses to not be a potential auditor of the company, but instead to provide advisory services to maintain the company as a client. This is *not* the opinion of the academic and professional articles. The overall opinion was that the rule actually would

enhance and ensure auditors' perceived independence. ICAEW concluded in their article that mandatory audit firm rotation would have a positive impact on auditors' independence (ICAEW, 2002, p. 2), and this was also one of the arguments in favor of a re-establishing the legal requirement for it in Spain, as mentioned in the article by Carrera et al (2007). However, the audit profession had the last saying in this manner as they thought that it would only generate distortion in the market, as stated by the president of KPMG in Spain, Mr. J. L. Pérez Rodríguez, whom instead recommended *audit partner* rotation (the statement can be found in section 5.2.1). The two bankers whom we interviewed, which is an interested party according to the stakeholder-model mentioned in section 3.1.1, believed that auditor independence is important since they put a lot of trust in the audited financial statements since these could be used, for instance, as a tool to determine the credit worthiness related to a specific borrower. One banker stated the following:

“Financial statements are of great importance and constitute the backbone in our credit analysis work. The credit worthiness of a borrower, in other words, rating and financial ratios, is to a large extent determined by information contained in the audited financial statements”.

Both the bankers responded that it is difficult for banks to protect themselves from biased audit or fraud, but that they have the privilege to discuss any credit related concerns with the borrower, for instance how the auditing was conducted if they felt uncomfortable with the result, and that it would affect the assessment of the borrower's credit worthiness. But they both believed that a mandatory audit firm rotation could increase the confidence for the financial statements for the stakeholders. One of the bankers also believed that the financial statements would have a higher credibility. They also mentioned that they do not discuss the topic mandatory audit firm rotation on a daily basis and that they do not pay much attention to it unless a scandal, such as Enron, recently have occurred. One banker perceived that the rule could prevent future scandals and crises, since the audit firms have the Enron scandal and the collapse of the audit firm Arthur Andersen fresh in mind. He also meant that the audit firms build their credibility and reputation based on the society's and stakeholders trust, where any revealed inconsistency or biased accounting would be devastating for them. RL 21 § statutes, through the analysis-model mentioned in section 4.2.2, that if there are any circumstances that could impair the trust in the auditor, such as the threats mentioned in section 3.3 and in RL 21

§, the auditor should decline or resign from the assignment (Revisorslag (2001:883), 21 §). This means that an auditor always has to be careful and to thoroughly control the client's financial documents to find any inconsistency or biased accounting so that their credibility and reputation is maintained, as well as the society's trust. The other banker has a different opinion whereas the risk for scandals and crisis would be unchanged as long as the audit firms perform audit and advisory services for the same company. Essential steps, mentioned in the Swedish Proposition, that can be used when detecting, documenting as well as minimizing and, if it is possible, eliminating threats, as mentioned in section 3.3, to the auditor independence in mind and in appearance, is to have procedures for consultation of independence issues and to create a frequently documented and monitored control system within the audit firm and to have an organizational structure in the audit firm where any additional activity is *separated* from the audit activity (Proposition 2000/01:146, p. 100). This means that the Proposition is not as though as the banker would have wanted it to be.

There were also a variety of comments, such as those expressed by the Confederation of Swedish enterprise, the audit committee of Admiral as well as Ernst and Young, which stated the opinion that *key audit partner* rotation is enough to secure auditors' independence. This confidence in the current legislation was also expressed in our interviews with the auditors. FAR, Assirevi and Grant Thornton stated that they have a higher confidence in IESBA's Code of Ethics, combined with *key audit partner* rotation, than in *audit firm* rotation.

8.3 Audit quality, familiarity threat and the loss of knowledge

Auditor independence is a contributing factor to financial statement user's confidence in the financial reporting process because it ensures quality audits (Lindberg and Beck, 2004). ICAEW concluded in their article that audit quality would be improved by an introduction of mandatory audit firm rotation because of the avoidance of the familiarity threat, which would also affect auditors' independence positively (ICAEW, 2002, p. 2). The interviewed auditors had a different opinion than ICAEW, where they thought that the familiarity threat would *not* be affected by the rule. The reason for this is that they try to have an absolute professional relationship with their audit clients and because they believe that it is sufficient to rotate the audit personnel within the audit team. One auditor responded that a long relationship between the auditor and its client often is an advantage because of the created familiarity and acquired knowledge, and that this connection would be lost if the rule would become mandatory. The

majority of the comments thought that *audit partner* rotation and IESBA's Code of Ethics is enough to reduce the familiarity threat. ICAS has an interesting aspect that no other comment had, which was that there is a rotation in the audited companies as well; since chief executives and financial directors in the UK listed companies are being replaced on a fairly frequent basis. Two auditors also pointed out that there is a high risk that important information would be lost, but that there would be a deeper discussion when the exchange between the new and the old audit firm takes place and that Sweden might need a better system for the audit firms to share information. The experiences from Italy, when they first adapted to the rule in 1974, are that an exchange of information between audit firms needs to be regulated. If the Swedish regulators would allow the main auditor to rely on the work of a secondary auditor in the Swedish accounting law, a Parmalat-scandal may possibly take place in Sweden as well. It does not exist any Swedish accounting rules about the exchange between audit firms regarding the audited company's *information* (See section 4.2). The new proposal in Sweden does, however, only recommend key *audit partner* rotation and not mandatory *audit firm* rotation. The reason for this is that the disadvantage of rotation and change of auditor is that specific knowledge of the audited company could be lost which could have a negative impact on the audit's efficiency and reliability, and therefore on the audits quality. The Department has thus regarded any problems with a loss of knowledge at the time of *auditor rotation* as limited and therefore to be a better alternative than mandatory audit firm rotation (Ds 2012:4, p. 20). One auditor stated the following:

“We will never get first-hand information when we take over a new company, but we always try to catch up the most essential discussions in the company.”

ICAEW also concluded that the quality of the audit could be adversely affected because of the lack of familiarity and knowledge in the early years of the audit (ICAEW, 2002, p. 2). This argument is supported by Carcello and Nagy's study where a former SEC Chairman, Mr. Roderick M. Hills, stated the following:

“Forcing a change of auditors can only lower the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. To change every several years will simply create a merry-go-round of mediocrity” (Carcello and Nagy, 2004, p. 3).

Carcello and Nagy (2004) concluded that the legal requirement actually could have adverse effect on the quality of the audit and that it would create a lack of knowledge about the client, which would lead to a higher risk of fraudulent financial reporting occurring in the early years of the audit engagement (Carcello and Nagy, 2004, p. 6). All our interviewed auditors were also *against* the assumption that mandatory audit firm rotation could increase audit quality. One of the auditors build his argument on research which had shown that the major mistakes in an audit occurred during the first two years of an audit engagement because it takes time to get to know a new client and their specific risks. He also said that it could take two-three years before the new audit firm is equal effective as the previous auditor. Another auditor responded that it would be harder to motivate the audit team to make certain larger audit procedures one year which will give advantages in the following year's audits if there is a legal requirement for audit firm rotation. The reason for this is that there is a risk that the audit firm does not want to take on that cost since it would not gain their audit firm. A third auditor mentioned that a lack of focus and a decreased feeling of commitment would be the outcome if an audit team and audit firm knows that they will be replaced no matter what. The two interviewed bankers responded that they perceive that the audit quality is good in general in the financial statements that they receive, but that there could be a difference between larger corporations, which have been audited by big established audit firms, with smaller companies from countries with different audit praxis where the quality is more questionable. One of the bankers believed that the audit quality would be unchanged; whereas the other thought that it would increase the quality and stated the following:

"All business relations are to some extend personal between people. If you for the seventh year in a row shall perform an audit for the same company and persons, it is very hard to be objective and point out faults."

This respondent built his argument on that it would be beneficial to get "new" attention on the company in question and, despite the fact that it would be expensive, that the company needs to perform this sort of analysis anyway since much happens in big companies during a period of seven years. The other banker argued that there would be a loss of important knowledge and information. The main reasons by the auditors against the rule were the loss of knowledge, information, continuity and company history, whereas one auditor's argument were that an audit team, in some audit engagements, consist of many people which have

acquired knowledge about the company in question, and if they would be replaced every sixth year, their knowledge would be lost and that it then just would be a waste of resources. This was also the Swedish Department's opinion in the new proposal where they believed that the disadvantage of audit firm rotation and change of auditor is that specific knowledge of the audited company could be lost which could have a negative impact on the audit's efficiency and reliability (Ds 2012:4, p. 20).

The interviewed audit firms had different thoughts regarding how the rule would affect their audit firm. This depended on how large market share of the listed companies they had. One respondent did not believe that the audit firm he worked for would be affected and referred to Brazil where the market shares were stabilized after a period of time. Another auditor thought that there would be an impact but that they would not lose much in revenue, while a third auditor believed that it would have a positive impact on his audit firm in Sweden, whereas the global organization at a whole would be negatively affected. A mentioned drawback of the rule in the article by ICAEW is that the signals, either good or bad, that may be given out when changing an auditor will be lost. The interviewed auditors also mentioned that their clients do not like to change auditors as this could signal, according to us, that they are hiding bad news. The main argument, against the argument that mandatory audit firm rotation would increase audit quality, is that there is no evidence that supports such a statement. Deloitte said in their comment that they had not found any evidence that audit quality will increase with the rule. PWC used a different angle when they stated that an evidence of good audit quality is the low rotation of audit firms today. They also use the argument that audit firm must deliver audits with high quality to be competitive. The only comment that had empirical data to support their opinion was AICPA, and their investigations stated that the rule does not increase audit quality. A similar conclusion was presented in ICAEW's comment, which gave a reason to why countries that have had mandatory audit firm rotation now have moved away from it. The reason for this was concerns for the audit quality. Admiral's audit committee said that the reputational risk for the larger audit firms is too big and that there, therefore, would not be any change in audit quality. Ernst and young gave the example that audit committees should explain how the audit quality has been assessed and that it could be a way to increase the transparency with audit quality.

8.4 *New fresh look*

One of the arguments in favor of mandatory audit firm rotation in the articles was the fact that a new auditor gives a new “fresh” approach to the audit. This would protect the stakeholder who relies on the financial reporting, such as the shareholders and creditors (GAO, 2003, p. 15). It was stated in ICAEW’s article that it would be an opportunity to have a fresh look to the audit (ICAEW, 2002, p. 2). This was also the main perceived benefit of the rule by all of our interviewed auditors. One respondent mentioned that it takes a lot of time for a new auditor to learn the client’s business, but, on the other hand, that this could result in a more detailed audit and that many stones would be turned that maybe has not been turned for a couple of years. The same respondent answered that it could sometimes be good to change a supplier of services, but if this change should be mandatory is uncertain. Another auditor responded that the rule could enhance auditors’ independence as it is good with a different approach, but that the mandatory key *audit partner* rotation and the fact that there are a ten-fifteen percent of changes within the audit team every year already, creates a good balance between continuity and providing new “fresh” eyes to the audit. The new proposal by the Swedish Department also believed that the alternative to *audit firm* rotation, that is, *auditor* rotation, is enough and that a mandatory *audit firm* rotation could have a negative impact on the audit’s efficiency and reliability (Ds 2012:4, p. 20). It was only ICAS that had thought about this matter in their comment and they stated that the personnel in the audited company also change over the years. There is no status quo in either the audit teams or the companies. It is interesting to notice that all our interviewed saw the advantage with new eyes on an audit while only one of the comments did.

The U.S.’s experiences from the collapse of Enron are that new “fresh” eyes are needed. If they would have a legal requirement for mandatory audit firm rotation, the improper audits made by Enron’s audit firm Arthur Andersen and the severe misstatements in the financial statements would have been detected (Porter, Simon and Hatherly, 2008, p. 45ff). Italy’s experiences from their legal requirement for mandatory audit firm rotation are that a new “fresh” look is needed. However, the mistake in the Italian accounting law in 1974 was that they allowed that the main auditor could rely on the work of a secondary auditor. This consequently lead to that Deloitte was not required to control the work performed by Grant Thornton and was therefore not responsible for its accuracy (Buchanan and Yang, 2005, p. 45f). This resulted in that the advantage with a new “fresh” look never was used when auditing Parmalat’s financial statements.

8.5 *The associated costs*

The experiences of the countries that have introduced the requirement, and some have subsequently removed it (Austria, Spain and Canada); have been reviewed in the articles by Cameran, Di Vincenzo and Merlotti and ICAEW (Cameran, Di Vincenzo and Merlotti, 2005, p. 7f and ICAEW, 2002, p. 1). These experiences together with other articles' discussed advantages and drawbacks of mandatory audit firm rotation, indicates that the requirement is generally not believed to be cost-effective. ICAEW concluded that the additional start-up cost would affect both the audit firm and the client (ICAEW, 2002, p. 2). The Swedish Department's opinion in their new proposal is that a newly appointed auditor must understand the company's specific situation, which is an often time-consuming process that is also very costly for the company being audited (Ds 2012:4, p. 20). With *auditor* rotation, the associated costs with changing audit firms would therefore be limited. The majority of the interviewed auditors stated that the rule would increase the audit cost for the clients due to the increased workload. The reason for this is that the audit team spends about 30-40 percent more time on the audit during the first year of the audit engagement since they need to acquire a lot of knowledge and an understanding about the client's company. In the end, the clients would pay the increased time. The cost aspect is also mentioned in the comments from the Swedish shareholders association, ICAEW, ICAS, British foods plc. and AICPA. The audit and compliance committee of Standard Life plc. said that it would be a cost that does not add any shareholder value.

Cameran, Di Vincenzo and Merlotti (2005) concluded that the motivation to invest in a specific industry would be reduced for the auditors. One auditor responded similarly and that large investments in the beginning of an audit relationship are very costly since much time is spent on creating an understanding of the client's company and also building a structure, which in some cases could extend over numerous countries. It could be hard to charge the client for some of these costs, whereas they must instead be considered as sunk costs by the audit firm. One argument in favor of the rule in Cameran, Di Vincenzo and Merlotti (2005) was that it would increase competition and that this in turn would decrease the audit price for the first year. The price would, however, become higher in the subsequent years, which is called "low-balling". One auditor responded that there could be a price pressure where the audit firm would have to do more work for less audit fees. The reason for this is that it takes a lot of time to acquire knowledge about a new client and its company. This could, on the other hand, result in a decrease in the audit quality. One must also consider that the rule could be a

less costly alternative to audit failures. However, instead of adapting to mandatory audit firm rotation, the U.S.'s SOX made nine rules, prohibiting non-audit services inconsistent with auditor independence, into law and adapted to *auditor* rotation (Lindberg and Beck, 2004). The reason for this was because the U.S. Congress felt that the previous research that existed in the area of *audit firm* rotation was too limited and not sufficient to predict the potential impact and effects on the American market (GAO, 2003, p. 2). It could also have been to protect the audited companies from higher audit fees, which they would have been charged if *audit firm* rotation instead had been introduced.

8.6 Audit failures

One argument against an introduction of mandatory audit firm rotation in Cameran, Di Vincenzo and Merlotti (2005) was that the risk for audit failure would be higher in the audit engagement's first years. This is *not* consistent with the answers from the interviewed auditors. They believed that the number of audit failures would remain on the same level as it is today. One auditor stated:

“Nothing is indicating that mandatory audit firm rotation will decrease audit failures. There are some incorrect assumptions in the EU proposal that the lack of auditor independence was one of the reasons for the financial crisis in 2008. I do not believe that you could blame the audit profession for crises. There are other variables that are more vital in creating financial crisis.”

Cameran, Di Vincenzo and Merlotti (2005) also thought that the rule would decrease the occurrence of audit failure in a long-term perspective, but one of our interviewed auditor do not believe that a 100 percent security level can be reached with regulation. The reason for this is that there will always exist a risk that people will try to go around the law in ways that are hard to find out. He consequently thinks that it is important to have internal controls of their own work by an independent auditor who has not been involved with the audit client in question. Two auditors responded that audit failure would not increase since the former audit firm will make sure that they have investigated the essential and that they have explained their work to the new audit firm. The reason for this is because they want to make sure that the new

audit firm cannot find any mistakes from previous years since they do not want problems in the future. One of the auditors said that it is also a responsibility for the new audit firm to make sure that they have the right competence regarding the new client, its business and industry and to ask for information. This is *not* the opinion of another auditor who claims that the big audit failures can decrease because of mandatory audit firm rotation, but he also said that there is a higher risk that restatements instead would increase because of the mistakes that an audit firm does because it is new on the assignment. There were only two comments that gave examples of when the audit risk could increase. Associated British Foods plc. stated that the lack of knowledge and understanding of a company could increase the audit risk. This is in line with what our respondents said in the interviews. One example when an increased audit risk could occur was given in the comment from KPMG, and they stated that there could be a situation when a mandatory rotation takes place in a period when the auditor's knowledge and routine is vital for the company's survival.

8.7 The overall opinion and alternatives

The improvement of auditor objectivity and independence has been argued within the reviewed articles to be a main reason for the introduction of mandatory audit firm rotation. There has also been much discussion regarding other potential positive effects of the rule, but our study indicates that academics, professionals, regulators and other interested parties have struggled to identify direct evidence that the rule would be positive. When we have reviewed the arguments against mandatory audit firm rotation, it seems that the most mentioned are those related to decreased audit quality, the lack of knowledge about a client and its business, which would in the early years of the audit engagement result in increased audit costs for both the auditor and the client, which is also a result of the lack of familiarity. If mandatory audit firm rotation were implemented, the shareholders' right to decide when, or even if, a new audit firm should be appointed, would be limited. This is something that many of the comments see as a negative consequence, which is also the opinion of our interviewed auditors. On the other hand, one respondent perceives that there exists a lack of understanding from shareholders and other stakeholders, what an auditor in reality actually does. Consequently, the shareholders should perhaps not have the same amount of power regarding the appointment of the auditor and audit firm.

Key *audit partner* rotation would be a less costly alternative according to some of the reviewed articles. They believe that a rotation of the engagement within the audit firm would be a better alternative to mandatory audit firm rotation. The reason for this is that the acquired knowledge about the specific client and its company would be available within the audit firm, and that the impact on audit quality and the associated cost would be significant less than that resulting from the rotation of audit firms. This is also the opinion of one of the interviewed auditors who stated that the *auditor partner* rotation, which exist in Sweden today, already enhance auditors' independence and all the interviewed auditors believed that the current regulation are sufficient and that mandatory audit firm rotation therefore is *not* necessary. This opinion is also supported by the majority of the comments, such as by FAR, the big four audit firms, Grant Thornton, Mazars, Assirevi, ICAS, Swedish corporate governance board, the Confederation of Swedish enterprise and Standard Life plc.'s audit and compliance committee. The Swedish Department also believes that auditor rotation is enough and has chosen to only recommend this alternative in their new proposal (Ds 2012:4, p. 20).

However, we will now discuss three intended benefits with a mandatory *audit firm* rotation, which could not be applied for *audit partner* rotation. The first benefit that has been mentioned in the reviewed article is the society's perception of enhanced auditor independence. This benefit is important from a stakeholder-perspective since they need to be able to rely on the audited financial reporting and because auditors need to have the society's trust (see section 3.1 and 3.1.1 for the role of the auditor and the stakeholder model). A second mentioned benefit in the articles is the assumption that the competition amongst audit firms would increase. This has, however, been widely discussed and the outcome is different in the articles, whether it in fact would increase or decrease the competition. A third benefit that has been mentioned in the articles is that the long-term relationship between the audit firm and the client would be avoided. It would therefore not exist any risk for the auditor to overlook or to accommodate management's viewpoint on financial reporting issues to be able to maintain the financial rewards from the audit, as mentioned as a consequence of the familiarity threat in section 3.3. Mazars and BDO feel that the tendering could be improved. Larger listed companies rarely come out on tendering for audit services, and when it does, the period is short and not open for all audit firms. BDO thought that the companies themselves should decide tendering, but that the companies should, in the spirit of good corporate governance, explain why the company does not put out the audit on tendering. Mazars expect that a tendering would take place at intervals and at least every ten-twelve year. Mazars and BDO

comments can be explained by their market position, which are under the big four. The Swedish Shareholder Association anticipated in their comment that the market domination by the big four would be impaired if the rule were implemented and they stated that the big four's market share almost is unacceptable in Sweden today. SET is the only audit firm that said that the market concentration could decrease if mandatory audit firm rotation and shared audits engagements are implemented together. This argument is difficult to respond to since SET is the only part that has lifted this question.

Nevertheless, as mentioned above, the majority of the articles, comments and interviewees believed that mandatory audit firm rotation is a too costly and not efficient enough. They therefore instead recommended other less costly alternatives for ensuring auditors' independence and objectivity. The FEE study mentioned alternatives such as that the audit firms' work could be supervised by an effective external oversight body and the rotation of *audit partner* (FEE, 2004, p. 3). One of the interviewed auditors also recommended that a second independent partner should review the audit teams' and audit firms' work as well as independence. The reason for this is the importance of internal controls within the audit firm to control the audit quality.

9. Conclusions

In this chapter we will present the conclusions that we have reached during the analysis of our empirical and theoretical material. We will also highlight the areas that may be relevant for further research.

9.1 Conclusions to our research questions

We will present our conclusions under respective research sub-question and end with an answer to our main research question.

9.1.1 *How is the mandatory audit firm rotation proposal perceived by the audit profession and financial institutions?*

Both the audit profession and financial institutions are sceptical to a mandatory audit firm rotation. They perceived the rule as a step backwards in the development progress of the audit market and a strong limitation of the free market and the rights of the shareholders. The two believed that a mandatory audit firm rotation would not be as effective as the commission states. There are better alternatives according to the two stakeholders, whereas the audit profession believe that key audit partner rotation could be a better alternative and the financial institutions believe that a separation on audit services and consulting services is a better solution than a mandatory audit firm rotation. The audit profession and financial institutions opinions about the rule is shared by other stakeholders. This is shown in our triangulation method, and our three studies have all concluded that there is very little support for a mandatory audit firm rotation. All our studies suggested less costly alternatives, such as key *audit partner* rotation, transparency in the tender process and to extend the audit report with the intention to increase the stakeholders' understanding of the auditor's role, where the intended benefits of the rule also could be achieved, at least to some extent.

9.1.2 *How have the United States, Sweden and Italy protected auditor independence and how have they adapted to mandatory audit firm rotation?*

The independence of auditors is of great significance as the main reason for an introduction of mandatory audit firm rotation is to protect and enhance the independence as a safeguard (ICAEW, 2002, p. 11). The reason for this is because independence is seen as an important

way for ensuring that the work performed by the auditor is credible (Porter, Simon and Hatherly, 2008, p. 65). In order to restore the public trust in the audit process after recent accounting scandals in the U.S., new auditing regulations were introduced and included more severe penalties to protect from fraudulent behaviour. To maintain and protect both independence in appearance and in mind, the application of *audit partner* rotation were adapted and implemented plus nine rules concerning non-audit services inconsistent with auditor independence were made into law by SOX (Pott, Moch and Watrin, 2009, p. 209ff). The U.S. has not adapted to mandatory *audit firm* rotation and the reason for this was because the U.S. Congress felt that the previous research that existed in the area of *audit firm* rotation was too limited and not sufficient to predict the potential impact and effects on the American market (GAO, 2003, p. 2).

Sweden has also adapted to *auditor* rotation, with some restrictions, which the Swedish Department want to expand and has therefore in 2012 developed a new proposal in Sweden to protect auditor's independence and to complement the existing rules (Ds 2012:4, p. 18ff). The proposal does, however, suggest that audit firms, which only consist of one auditor, in fact, has to be a part of mandatory '*audit firm*' rotation, since they are not allowed to participate in the assignment during the waiting period of two years. This could result in the possibility that the next development in Sweden is to introduce mandatory *audit firm* rotation. The reason for the new proposal could be because it is unclear whether or not the current rules of independence and the analysis-model in RL 21 § in Sweden is enough to secure auditors' independence. Nevertheless, the interviewed auditor believed that the current rules are sufficient since they already have guidelines as well as education in the subject and that mandatory audit firm rotation is *not* necessary. This was also the Swedish Department's opinion in the new proposal where they believed that the disadvantage of audit firm rotation is that specific knowledge of the audited company could be lost which could have a negative impact on the audit's efficiency and reliability, and therefore on the audits quality. The Department has thus regarded any problems with a loss of knowledge with *auditor rotation* as limited and therefore to be a better alternative than *audit firm* rotation (Ds 2012:4, p. 20). The reason for that there is no equivalence to SOX's eight rules in the Swedish accounting law is that the Swedish government has taken into account the fact that a company's auditor already has knowledge about the organisation and that the client probably would save some costs if he would turn to his auditor for advices on his business. The Swedish government therefore

decided not to implement prohibitions regarding the auditor and on services to their audit clients that are not audit activities (Proposition 2000/01:146, p. 52f).

Italy adapted to mandatory audit firm rotation and introduced it as a legal requirement in 1974 as the rule was assumed to protect and enhance auditors' independence (Cameran, Di Vincenzo and Merlotti, 2005, p. 7). The problem with the Italian accounting law of the time was that it included that the main auditor was allowed to rely on the work of a secondary auditor. In the Parmalat-scandal, the rule meant that Parmalat had to change auditors every nine years and they therefore changed from Grant Thornton to Deloitte. The accounting law led to that Deloitte was allowed to thrust Grant Thornton's work and not control it themselves and that Deloitte consequently was not responsible for its accuracy. This resulted in that the advantage with a new "fresh" look never was used when auditing Parmalat's financial statements. New rules regarding main and secondary auditors, which were equivalent to the international auditing standards, were introduced in Italy in 2003. One reason for this was to protect themselves from financial scandals as well as to protect auditors' independence and as these rules required the main auditor to *re-consider* the secondary auditors significant findings, Parmalat's accounts on Deloitte's behalf was questioned, which in the end led to that Parmalat Finanziaria SpA filed for bankruptcy protection (Buchanan and Yang, 2005, p. 45f).

9.1.3 How is the debate about mandatory audit firm rotation proceeding amongst academics, financial institutions, audit firms, public authorities, organizations and professional bodies after the EU Green Paper was published in 2010?

There were many comments to the Green Paper when it was released in 2010. Once again was mandatory audit firm rotation on the agenda. Academics, audit firms and professional bodies are the most active participants in the debate, but organizations that would be affected of a mandatory rotation are also keen to make a contribution to the debate. We could also see that all contributions to the debate have a strong intention to benefit the publisher's own interest. This is clarified when we study the differences in the answers between the comments and the interviews. The intense and extended debate focuses on the advantages and disadvantages with mandatory audit firm rotation and Italy are often used as an example to show that the rule would not provide a solution to the auditor independence problem. The example with high market concentration to the big four in Italy is also regularly highlighted in the debate.

Since most of the above mentioned stakeholders are against mandatory audit firm rotation, the disadvantages are highlighted in their contributions to the debate. But then again, with some aspects of the debate, it is hard to decide if the debaters see audit firm rotation as an advantage or disadvantage. This since there is hardly any actual evidence and there will always be room to question the evidence and fact that is presented in the debate about the rule. Examples of such aspects mentioned above are whether the competition in the audit market, audit quality and audit failure will increase or decrease with mandatory audit firm rotation. While the bureaucratic process in the European Union takes its time, the debate today is slumbering while awaiting the outcome of the proposal.

9.1.4 What advantages and disadvantages are perceived for mandatory audit firm rotation?

The opinion found in the articles and by some of our interviewees is that there would be a positive impact on auditors' independence in appearance, which means that the familiarity threat will be reduced. The reason for this is that there would be a greater distance between the auditor and its client, and this is often pointed out as the main advantage with mandatory audit firm rotation. This is also the main argument why there is a legal requirement for it in Italy, Brazil, India, South Korea and Singapore (Cameran, Di Vincenzo and Merlotti, 2005, p. 14f). The fresh approach to an audit that a new auditor has is also an advantage that is stated by both the articles and in our interviews.

Three disadvantages are mentioned in all three studies. *First*, the additional costs that occur when mandatory audit firm rotation take place. The cost is generated by inefficiency in the audit firm since they must build up an audit structure and gather knowledge about the client. *Second*, the increased audit risk during the first couple of years when having a new audit firm. This risk is the result of low knowledge and routine on the part of the client business and risks. A consequence is that during the audit period of six years, there would only be three or four years left for high audit quality, as mentioned by one of our interviewed auditors. *Third*, the loss of knowledge that would occur when an audit firm must leave the client, as the knowledge that the old audit firm has built up during the engagement would not be possible to transmit to the new audit firm. This is regarded as a waste of resources by one of our interviewees.

9.1.5 Could mandatory audit firm rotation improve audit quality?

As a result of our review, as presented in the analysis, we do not believe that mandatory audit firm rotation is the answer to solve the problem with auditor independence. We instead think that the suggested rotation of key *audit partners* and *audit teams* are sufficient. An argument for that opinion is that there is annual natural change of personal in both the audit firms and the client's firms. This fact seems like a working mechanism that at least minimizes the problem with familiarity and therefore the problems with auditors' independence at a lower cost for both the audit firm and the client. One of our largest concerns about mandatory audit firm rotation is the loss of knowledge; this is a problem that must be solved in an effective way. The audit quality could to some extent be affected by the loss of knowledge and by that fact that some auditors would not do some procedures in the auditing process when they know that they will be replaced no matter what. Through our triangulation method, we have not found any evidence that mandatory audit firm rotation will improve audit quality. Based on our three studies, we can conclude that there is *no* support for mandatory audit firm rotation since the disadvantages outweigh the benefits and that it is perceived as an unnecessary procedure without any actual evidence of fulfillment of the intended purposes and does therefore not improve the audit quality.

9.2 Proposals for further research

When the EU parliament votes about the Green Paper, the answer will depend on to which extent the Green Paper is accepted and implemented. If mandatory audit firm rotation were implemented, there would be many research topics that would be interesting to investigate, such as how auditors' independence has been affected. It could be interesting to investigate if the audit firms audit methods has changed since there is new circumstances for their working environment. Since the purpose with the Green Paper and the proposal for regulation is to break the dominance of the big four, a research about competition and market shares after ten-twelve years could be a good idea to investigate and it could be a way to evaluate if the effects were as intended. It could also be interesting to interview the companies that would be affected by the rule and how they perceive it. To acquire a more global perspective to the problem with auditor independence; it could be a good idea to interview auditors in countries where audit firm rotation is mandatory.

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Interviewees

We have interviewed auditors and bankers at KPMG (2012-05-03), PWC (2012-05-03), Deloitte (2012-05-10), BDO (2012-05-04), SEB (2012-04-19) and HSH Debt Advisory ApS (2012-05-08).

Appendix 1

Questions to the audit firms:

- 1) How much does your audit firm discuss the EU proposal about mandatory audit firm rotation?
- 2) Do you think that a mandatory audit firm rotation would increase the auditors' independence?
- 3) Which advantages do you consider that mandatory audit firm rotation has?
- 4) Which disadvantages do you consider that mandatory audit firm rotation has?
- 5) How do you believe that mandatory audit firm rotation would affect your audit firm?
- 6) How do you believe that mandatory audit firm rotation would affect your clients?
- 7) How does your firm prepare for mandatory audit firm rotation?
- 8) Do you think that audit failures would increase or decrease if audit firm rotation was mandatory/ implemented in Sweden?
- 9) Do you think that it would decrease or enhance different threats? For instance, the familiarity threat?
- 10) Do you think entity-specific knowledge would be lost?
- 11) How do you believe that mandatory audit firm rotation would affect audit quality?
- 12) What is your suggestion to increase audit independence?
- 13) Is there something you would like to add, something that has not been asked about mandatory audit firm rotation?

Questions to investors in the financial institutions:

- 1) Of what importance are financial statements in your work?
- 2) In what purpose do you use annual reports in your work?
- 3) Are people in your business aware about the problem with audit independence and the effect it could have on audit quality?
- 4) How does your industry deal with auditor independence problem?
- 5) Have you ever doubted the audit quality on the annual reports that you have worked with?
- 6) If so, how did that affect your decision?
- 7) Have you heard about the EU proposal about audit firm rotation?
- 8) As a user of annual reports, would you have higher confidence for the reports if audit firm rotation were used?
- 9) Do you think that audit firm rotation will affect audit quality?
- 10) Would the credibility of annual reports be higher if the audit firm rotation was used?
- 11) Do you think that the rule would prevent future financial crisis and corporate scandals?
- 12) What suggestion do you as a user of annual reports have to increase auditor independence?
- 13) Is there something you would like to add, something that have not been asked about mandatory audit firm rotation?