Mandatory Audit Firm Rotation:

A cure or a placebo?

Research question:

Should the introduction of a system of mandatory audit firm rotation as proposed by the European Commission be implemented in the European Union?
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Abstract: The European Commission wants to change the current regulatory framework with regard to the auditing sector. Companies that can be seen as Public Interest Entities should on a mandatory basis periodically rotate their audit firm. Both internal and external rotation has been a point of debate in the recent past and the recent changes the European Commission proposes for the audit market have re-opened this debate. The adoption of mandatory audit firm rotation has many possible outcomes that will have its effect on auditors, their clients, but also the general public and society as a whole. This study is aimed at finding the positive and negative effects that a mandatory audit firm rotation regime has on the audit market. The European Commission argues that accountants are influenced by their client and therefore lose their independence if the audit tenure lasts for many years. The solution they propose is mandatory audit firm rotation. In this thesis the influence of mandatory audit firm rotation on the independence of auditors, audit quality, audit costs and some other factors such as competition was analysed. Based on various studies the proposed changes will increase costs and inefficiencies for both auditors and their clients. Besides that, mandatory audit firm rotation reduces the quality of audits. There is also no clear evidence that mandatory audit firm rotation will increase auditor independence. These findings are strengthened by experiences from countries that have dealt with mandatory audit firm rotation rules. In the end it was concluded that mandatory audit firm rotation will not be able to achieve the goals set by the European Commission. In this thesis it is therefore argued that a mandatory audit firm rotation regime should not be adopted by the European Union and that better alternatives exist.
1. Introduction

During his hearing on January 20, 2010 conducted by the ‘Commissie-De Wit’, which is a temporary commission tasked with investigating the causes of the recent financial crisis in the Netherlands, accountant Jules Muis stated the following in Dutch, ‘de crisis was voorspelbaar en vermijdbaar’ (Kalse & Wester 2010). When translated to English his statement means that the economical crisis was predictable and avoidable. He also believes that the accounting sector failed in its auditing role and its social responsibility. He wonders what the added value of an accountant and his statements are if they play no role in signalling or preventing a crisis (Kalse & Wester 2010). He is not the only one who questions the role of the accountants since regulators and shareholder activists in Europe have been re-opening the issue of auditor independence by, among other measures, insisting on regulation that would oblige companies to periodically rotate their audit firm (European Commission 2011; Plasterk 2011). It is interesting to see that this discussion resurfaces since it has already been extensively discussed over a decade ago. At first it was mainly discussed in academic spheres by accountants and academics, but after the big financial scandals in the United States (The most famous ones: Enron and WorldCom) the discussion became broader and included politicians, legislators and public institutions (Cameran et al. 2005).

In the case of the Enron and WorldCom scandals accountants were rightly blamed. In the Enron scandal for example, large debts were hidden from the balance sheet by using derivatives and complex structures. However, in the light of the recent crisis it is highly debateable to what degree, if any, accountants can be held liable for current events. Accountants signal deficiencies in operations and audit the annual reports. They can take note of and report errors and abuses; however the question is in how far they can actually prevent a crisis. This thesis would answer the question with, ‘they cannot’. However, insofar accountants can be blamed for an economical crisis, the crisis did of course not only occur due to the possible shortcomings of the auditors. Rather, it occurred due shortcomings in a long chain of factors. Nevertheless, somewhere in the chain are the accountants who are tasked with approving the records. Thus they might partially be held responsible. The position

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1 This is a temporarily commission tasked with investigating the causes of the recent financial crisis (Tijdelijke commissie onderzoek financieel stelsel). Website in Dutch <www.tweedekamer.nl/kamerleden/commissies/COFS/index.jsp>.
3 Website with quote in Dutch <vorige.nrc.nl/economie/crisiscommissie/article2463436.ece>.
of the auditors has therefore already been extensively discussed, especially after the scandals around the change of the millennium. The WorldCom scandal and the Enron scandal in the United States had lead to the adoption of the Sarbanes Oxley Act. This act introduced mandatory rotation of leading and reviewing audit partners; they have to rotate every five consecutive years to be regarded as independent auditors (Section 203 (j) Sarbanes Oxley Act). As mentioned above the recent economical crisis has re-opened this discussion in Europe. Mandatory rotation of auditors has made its way to the agenda of the Netherlands and the European Union as a whole. Regarding this topic the European Commission issued a regulation proposal on November 30, 2011 (European Commission 2011). The proposal is two-fold and more far-reaching then its American counterpart. First of all the European Commission aims to reduce the concentration on the market for audits, and secondly it wants to protect auditor independence by mandating audit firm rotation. Under this regulation auditors of Public Interest Entities can only be appointed for a maximum of six years with a cooling down period of four years. There is no clear world-wide used definition of a public interest entity, the European Union however, describes it as an ‘entity which is of significant public interest because of the nature of its business, its size or its number of employees’ (Accounting Professional & Ethical Standards Board 2011). Two examples of Public Interest Entities are listed companies and financial institutions. With the proposed changes the European Commission strives to increase auditor independence, audit quality, audit market competition and financial market reactions. The implementation of this regulation would bring significant changes to the Member States of the European Union. Currently only Italy has mandatory rotation rules which have been in effect since 1974 (Cameran et al. 2005). However, this rule did for example not help to prevent the famous Parmalat scandal which will be further discussed in later parts of the thesis.

In the case of the Netherlands the Dutch parliament on February 14, 2012, approved legislation that forces companies to change their accountant every eight years, two years longer then in the proposition by the European Union (Piersma 2012). This legislation was adopted because (a majority of) Dutch politicians believe the auditing of companies and banks was insufficient. The reasoning was that accountants serve a public good and should not serve other interests because as the crisis shows their failure can damage an entire society. According to the Dutch parliament, the long-term relation between the accountant and the

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firm has a negative effect on the independence and the critical view of the accountant (Piersma 2012; Plasterk 2011). A part of the accounting sector is not happy with this new legislation as they say it will lead to higher costs and audits of lower quality. Some people, however, believe the new legislation will have a positive effect. On the world-wide level, the arguments used by parties both in favour and opposed to auditor rotation are usually related to the following points (Institute of Chartered Accountants in England & Wales 2002):

1. Auditor objectivity and independence
   - rotation aimed at increasing independence of auditors
   - the perception of objectivity and independence
   - auditor rotation and opinion shopping
2. Quality of audit work
   - rigour of the audit process
   - incidence of audit failures
   - cumulative knowledge
   - investment by audit firms
3. Cost of audits
   - competition in the audit industry
   - costs of the first audits by auditors
   - cost of management time
4. Other practical considerations
   - audits of specialised industries
   - impact on freedom of choice

The aim of this thesis will be to determine whether the benefits of mandatory auditor rotation outweigh the costs of it. In other words would these rules be beneficial for companies and/or society as a whole. The main research question will therefore be:

*Should the introduction of a system of mandatory audit firm rotation as proposed by the European Commission be implemented in the European Union?*

This thesis will try to find an answer to this question by analysing both the arguments of the supporters and the opponents of mandatory audit firm rotation. While pursuing this goal the
The abovementioned discussion points will be used as guidelines. The idea of mandatory audit firm rotation is not new and has been extensively discussed (both internal and external) after the big scandals in the United States. This discussion had, as was already mentioned before, lead to the adoption of the Sarbanes Oxley act. The Enron scandal in the United States also meant the end of Arthur Andersen, who was before that time part of the ‘Big Five’ audit firms in the world. The situation created after the scandal can be compared with a situation of mandatory audit firm rotation and will be analyzed. The experiences in the United States and Europe with regards to this topic will also be used to come to a conclusion and answer the question.

In Chapter two of the thesis the advantages and disadvantages of mandatory audit firm rotation will be discussed based on various academic literature. In chapter three the unique situation that was created after the Enron scandal in the United States will be used to analyse the effects of mandatory audit firm rotation. In chapter four the European experience with mandatory audit firm rotation will be studied using Spain and Italy as a case study. In the fifth chapter some proposals and recommendations will be made after which, in chapter six, the thesis will be concluded.

2. Mandatory audit firm rotation: pros and cons

An auditor has two valuable roles within the capital market. First of all they have an information role and second of all they have an insurance role (Cameran et al. 2005). Cameran et al. can be quoted stated: ‘they give an independent verification of the financial statements prepared by managers and can prevent conflict of interests between managers and shareholders, thus enhancing the value of companies’ (Cameran et al. 2005).

As mentioned in the introduction part of the thesis some believe that the periodical rotation of audit firms should be mandatory for companies in order to even further enhance the value of companies. This idea has lead to the proposal of the European Commission in a regulation draft (European Commission 2011). This proposal is derived from the Green Paper of the European Commission called ‘Audit Policy: Lessons from the Crisis’ dating from 2010 (European Commission 2010). With the proposed regulation the European Commission wants to reform the professional standards of auditors. Their aim is to increase audit quality, increase auditor independence and to prevent further audit market concentration. The European Commission supports both mandatory rotation of audit firms and mandatory rotation of audit partners. They believe that auditors auditing a client for a long period of time
will become less independent because of various risks like familiarity, intimidation and self-interest (Michaela et al. 2011). Mandatory rotation would aid in eliminating those risks and thus make auditors more independent. In order to increase auditor independence the European Commission wants to introduce mandatory audit firm rotation. A company will have to switch audit firm after every six consecutive years with a cooling off period of four years. Internal rotation (partner rotation) requires changing the accountant within the audit firm while external rotation requires the replacement of the audit firm in total. Internal rotation is quite common as many countries including the Netherlands and the United States (introduced by the Sarbanes Oxley act) already have legislation that requires audit partner rotation. External audit firm rotation however, is very rare and only a limited few countries have mandatory rules regarding this matter. In a comprehensive study conducted in 2005, Cameran, Di Vincenzo and Merlotti compared 24 of the (back then) strongest (most industrialized) and emerging economies and concluded that only 5 of them had mandatory audit firm rotation rules (Cameran et al. 2005). This means that approximately 21% of the sampled countries had the mandatory audit firm rotation rule and 79% did not. The countries they sampled were: Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, India, Ireland, Italy, Japan, Luxembourg, the Netherlands, Portugal, Singapore, South Korea, Spain, Sweden, the United Kingdom and the United States. From these sampled countries only Italy, Brazil, India, South Korea and Singapore\(^5\) have mandatory audit firm rotation rules (Cameran et al. 2005). As mentioned before Italy is currently the only state in the European Union with audit firm rotation rules. Still it was unable to prevent the biggest scandal on the European Continent which was described by the Securities and Exchange Commission as ‘one of largest and most brazen corporate financial frauds in history’ (Ferrarini & Giudici 2006). In the past some European Union member states like Austria, Spain and Greece had mandatory auditor firm rotation rules but those rules are no longer applicable (Velte & Stiglbauer 2012). Originally the external rotation requirement was also to be included in the Sarbanes Oxley act; however, the General Accounting Office (this is now called the Government Accountability Office) in the United States expressed its objections against it and as a consequence it was never included in the act (General Accounting Office 2003). They based their objections on a study conducted by themselves called ‘Public Accounting Firms: Required Study of the Potential Effects of Mandatory Audit Firm Rotation’ The conclusion of this study was that there was no proof that mandatory audit firm rotation

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\(^5\) It is temporarily suspended in Singapore since 2008
was beneficial and that more experience with the effects of the Sarbanes Oxley act was needed (General Accounting Office 2003; Arel et al. 2005). It is also worth to note that most research done in this field is not in favour of mandatory audit firm rotation as they can also not find (‘strong’) evidence that these type of rules increase financial accounting quality, audit quality and independence (Velte & Stiglbauer 2012). Within the European Union only the Italian Association of Audit Firms (‘Assirevi’) seems to support a mandatory rotation regime because they believe it improves the independence of auditors (Cameran et al. 2005).

Already in 1998 The European Federation of Accountants and Auditors voiced its negative views on a mandatory audit rotation regime, still mandatory audit firm rotation is being proposed in the European Union and it has even been adopted in the Netherlands. This to great discontent of the Dutch accountant sector that claims that most European countries refuse to adopt such rules because it only works cost-increasing (Nederlandse Beroepsorganisatie van Accountants 2011). The ultimate question to answer is whether mandatory audit firm rotation increases audit quality and auditor independence and against what cost. In the upcoming part of the thesis the pros and the cons of mandatory audit firm rotation will be analyzed and dived into four parts. First of all auditor independence will be analyzed, after that the thesis will look at the effects that mandatory audit firm rotation will have on audit quality. As a third step it will look at the effect that mandatory audit firm rotation will have on audit costs. Last but not least it will look at other factors such market competition. The emphasis will be on public listed companies. The reason for this is that listed companies have separation of ownership and control; this makes auditing very essential to prevent corporate governance problems and get oversight of the company.

2.1 Independence

In this part of the thesis the focus will be on the relation between the independence of auditors and the mandatory audit firm rotation rule. Auditor independence can be described as, ‘the auditor’s willingness to report the irregularities detected’ (Arrunada and Paz-Ares 1997). The main argument the supporters of the rule give is that mandatory rotation of the audit firm will improve the objectivity and independence of auditors. The nature of an auditor’s works requires him to be in close and direct contact with its client. An auditor can get too comfortable or familiar when in a long-term relationship with a client and this could have the
result that an auditor would lose its professional scepticism and become less observant. Auditors might also be inclined to ignore small problems because it is financially rewarding to maintain a long-term relationship with a client. The independence of an auditor is thus relevant for the reliability and trustworthiness of the audit reports. Data collected from an experiment conducted by Dopuch, King and Schwartz, indicate that mandatory audit firm rotation rules will limit the frequent interaction between managers and auditors which in turn will reduce the chance of collusion (Dopuch, King and Schwartz 2001). However, it should immediately be noted that collusion does not only take place in long-term audit relationships, it can also occur in the early stages of a new audit relationship between auditor and client. Therefore mandatory audit firm rotation might not be the solution to solve the problem of collusion with the management.

In some academic circles it is believed that mandatory audit firm rotation regimes will increase the independence of an auditor. Independence is very important for auditors because even the presumed independence of the auditors can increase the credibility of the audit reports; it can also add value for several categories of stakeholders (Cameran et al. 2005). Auditor independence also influences the public opinion. The more the public perceives the auditors to be independent the more they believe that the auditors are performing their task properly in accordance with ethical principles (Cameran et al. 2005). Mandatory audit firm rotation is thus an appealing measure to create the appearance that the auditors are independent and fulfilling their task in a good way. A British study by Hussy and Lan supports the view that the public believes that auditors are more independent when mandatory audit firm rotation rules exist (Hussy & Lan 2001). They came to this conclusion after conducting a survey under 776 Chief Financial Officers in the United Kingdom (hussy & Lan 2001). Even though the surveyed financial officers believe that mandatory audit firm rotation rules will improve the independence of auditors, they worry about the negative effect it will have on the audit quality and the audit costs (Hussy & Lan 2001). In the end they believe the positive aspects of mandatory audit firm rotation do not outweigh the negative effects of it and thus do not support the implementation of such a regime. O’ Leary (an Australian researcher) came to the same conclusion. In his study 300 Australian companies and 180 audit partners were surveyed (O’ Leary 1996). Again a majority of the surveyed companies and partners (respectively 87% of the companies and 97% of the audit partners) did not support a mandatory audit firm rotation regime, even though they believed it would increase the perception of independence (O’ Leary 1996).
This thesis will continue with the effect mandatory audit firm rotation will have on the independence of auditors, the effect of mandatory audit firm rotation rules on the audit quality and audit costs will be discussed in a later part of this thesis.

If no mandatory rotation rules exist an audit firm would under normal circumstances like to keep a client as long as possible. To achieve this they will of course try to satisfy the client. This means that if an auditor is engaged in a continuing long-term relationship he might be more interested in the economic benefits of the relationship (keeping the client) then in staying as independent as possible (Gietzmann and Sen 2002; Cameran et al. 2005). Based on the abovementioned observation one could say that mandatory audit firm rotation rules could be beneficial to protect auditor independence. If an audit firm knows that it can be reappointed by its client the risk of colluding with the management of the client exists. When an auditor knows it will have to change its firm the focus will be less on client satisfaction and more on staying independent. An analytical research by Gietzmann and Sen also suggests this, however they make mention that their results are only meaningful for markets with specific characteristics (Gietzmann and Sen 2002). The results of their research suggest that mandatory audit firm rotation rules are only beneficial and a good political instrument when ‘audit markets are sufficiently thin, with a few large clients’ (Gietzmann and Sen 2002). In those types of markets mandatory audit firm rotation rules can protect independence. In so-called ‘developed’ audit markets (Broad market, many large clients) mandatory audit firm rotation rules are less beneficial. Auditors will avoid collusion with the client because it will damage their reputation, which in turn will cause loss of future business (Gietzmann and Sen 2002). In developed audit markets mandatory audit firm rotation rules would only lead to unnecessary costs.

In the light of these findings one has to look at what kind of market the European Union is in order to analyse the mandatory audit firm rotation rules proposed by the European Commission. In order to analyse the European market data on the number of domestic listed companies in the European Union was collected from the World Bank website. When analysing the European market one can see that there are great differences in the number of listed companies between the various Member States. Examples of European Member States that had a high number of listed domestic companies in 2011 (most recent data) are Spain, the United Kingdom, France and Germany. They respectively had 3241, 2001, 893 and 670 domestic listed companies (World Bank 2011). Some other European Union member states like Malta, Luxembourg, Hungary and the Czech Republic have significantly less domestic
listed companies. They respectively have 20, 31, 52 and 15 listed companies (World Bank 2011). The Netherlands have 108 domestic listed companies (World Bank 2011). Based on those statistics one can conclude that some domestic markets are developed and have many large clients while some domestic markets are thin and only have a few big clients. This means that some countries would benefit from mandatory audit firm rotations rules while others would not. It might therefore be more beneficial for countries to decide individually whether they want to adopt mandatory audit firm rotation rules or not.

As was already mentioned, a long-term relationship between a company and its auditor could harm the independence of the auditor. Opponents of mandatory audit firm rotation also agree with this but believe such a requirement would be excessive and unnecessary (Cameran et al 2005). They believe auditors have enough incentives to stay independent. The biggest incentive an audit firm has is to uphold its reputation. However, a Spanish research by Ruiz-Barbadillo and Gomez-Aguilar shows that reputation is not the first concern of an auditor. In their research they show that auditors are more dependent on their clients in the first few years of auditing (Ruiz-Barbadillo and Gomez-Aguilar 2002). Because of this fact auditors in the beginning of there audit period will try to go along (little disagreement) with their client because they want to recover their initial investment (Cameran et al. 2005). After the auditors recover their initial investment they will be more concerned about their reputation. Based on empirical research Ruiz-Barbadillo and Gomez-Aguilar conclude that after the initial years of auditing, the auditors become less compliant and more independent (Ruiz-Barbadillo and Gomez-Aguilar 2002). Even though this research was only conducted in Spain it suggests that mandatory audit firm rotation is not suitable for improving auditor independence. It can be concluded that auditors tend to be less independent in a short-term relationship than in a long-term relationship. Mandatory audit firm rotation rules might adversely affect auditor independence because it takes away the incentives for building and maintaining a reputation (Summer 1998). Many alternatives to mandatory audit firm rotation rules exist. For example mandatory internal rotation, but also the competition between audit firms and competition between capital markets are better alternatives to protect auditor independence (Summer 1998).

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6 <data.worldbank.org/indicator/CM.MKT.LDOM.NO>
In this thesis it is acknowledged that the closeness of auditors to management can be problematic. It was already mentioned that the nature of an auditor’s works requires him to be in close and direct contact with its client. Because of this closeness the auditor might lose its professional scepticism and become less observant. However, this thesis supports the view that mandatory audit firm rotation rules will not solve this risk of collusion and make auditors more independent. In order to perform their task auditors must interact with management on a daily basis. Whether the audit tenure is long or short, close interactions will always occur (Arel et al. 2005). This will always occur because clients must feel comfortable with their auditor otherwise they will be less inclined to share information and discuss problems with the auditor (Arel et al. 2005). An auditor needs to know the managers in order to estimate whether the client is sharing all relevant information or not. Gaining trust costs time and in a new audit relationship auditors and clients will have to get to know each other (Arel et al. 2005). A close relationship between auditor and client can have a negative influence on the independence of the auditor but on the other hand it is necessary because it is beneficial for the audit process. The continuity of an audit relationship increases the probability that auditors discover misconduct.

Risk of familiarity and trust will always exist in a long-term relationship between auditor and client; there should be a balance between necessary closeness with the client and independence. According to Dutch accountant (audit manager) Roos this balance already exists and mandatory audit firm rotation is therefore unnecessary in the European market. He is one of the Dutch accountants that do not support the adoption of this rule in the Netherlands (Roos 2004). He believes a system that requires periodic mandatory rotation for all companies better suits the American audit market rather than the European audit market (Roos 2004). The American audit market is one based on rules while the European market has an approach based on principles (Roos 2004). The American audit system describes what is, and what is not allowed, while the European system puts more responsibility with the accountants. When there are threats towards the independence of the accountant, the accountant in the European system has to protect its independence by ensuring that he takes additional safeguards based on the circumstances (Van Schaik 2002). In the most extreme independence threatening scenarios the auditor has to decline the job (Van Schaik 2002).

According to Roos each long-term auditor and client relationship also has natural forms of rotation (circulation) that have a mitigating effect on risks like familiarity and trust. In process of time changes will occur in the composition of the client, for example management will change and fusions and takeovers will occur (Roos 2004). This is supported by a study
conducted by the American Institute of Certified Public Accountants. In this study they state that within the hundred biggest public listed companies in the United States 68 percent of financial directors and 47 percent of general directors change their function within five years (AICPA 1992). Natural changes also occur within an audit firm. Some examples are restructuring, career development and specialisation. All these abovementioned facts show that there already are enough safeguards within the European audit market that marginalise threats to auditor independence. To get back to the Dutch situation, the Dutch Corporate Governance Commission believes that an internal rotation system is enough to protect auditor independence because it achieves the same pursued goals as external rotation (Commissie Corporate Governance 2003). If one would look at this problem from an international perspective, one can see that the international community is in general in line with the Dutch Corporate Governance Commission (Roos 2004). For example all European Union Member States, with the exception of Italy, have an internal rotation system. Most Anglo-Saxon countries like, The United States (Sarbanes-Oxley Act 2002), Canada (CICA 2003) and Australia (ICAA 2002) also have an internal rotation regime. Also within the European Union the mandatory internal rotation of auditors is stipulated as a measure that is sufficient to protect auditor independence (Mihaela et al. 2011). In Directive 43/2006 the European Commission already adopted the possibility to switch audit firms auditing Public Interest Entities if this is ‘appropriate for achieving the set objectives’ (Mihaela et al. 2011). This voluntary exception is more in line with the European audit market based on principles, which gives the auditors more responsibility to decide for themselves, then a forced regime would be. The International Federation of Accountants7, which on a world-wide level represents the accountancy profession, does also not support mandatory audit firm rotation. They name mandatory internal rotation as the safeguard to protect the independence of the auditors (Mihaela et al. 2011).

Mandatory audit firm rotation also brings the risks of abuse with it. It gives companies the possibility to drop an audit firm with a different point of view without generating public attention to it self. The switching of an auditor because the company is searching for an auditor with different opinions is called opinion shopping (Velte and Stiglbauer 2012) In normal circumstances when a company changes/drops its audit firm this will receive a lot of attention from the financial media and investors which will lead to many questions (Roos 2004). It is important to note that companies involved in fraudulent financial reporting have

7 It is active in 124 countries and represents more than 2, 5 million accountants.
often recently changed its audit firm (COSO 1999). This risk cannot occur with an internal auditor rotation system. The downside of this is, as was already mentioned, that internal auditor rotation is less visible to the public.

2.2 Quality

Another important aspect of auditing that needs to be analysed in light of mandatory audit firm rotation rules is audit quality. Audit quality can be defined as ‘the probability that an auditor will both discover and truthfully report material errors, misrepresentations or omissions detected in a client’s accounting system’ (De Angelo 1991). Jere R. Francis describes audit quality as ‘a theoretical continuum ranging from very low to very high audit quality’ (Francis 2004) he continues by saying that audit failure occurs ‘on the lower end of the quality continuum’ (Francis 2004). In order to perform his work in a decent manner the auditor needs to be objective, maintain due professional care and be free of interest conflicts (Cameran et al. 2005). According to Cameran et al. the main factors to analyse in order to determine the quality of the audits are (1) performance, (2) economic incentives and (3) audit market structure (Cameran et al. 2005). The first factor concerns both the knowledge and the experience of the auditor. The second one considers economical incentives; an audit firm’s performance is affected by economic considerations, for example fees, costs and profits (Cameran et al. 2005). The third factor concerns professional ethics, the visibility of the profession’s enforcement actions and interaction with professional peer groups; this influences the performance of auditors (Cameran et al. 2005). Supporters of mandatory audit firm rotation argue that it will improve audit quality because they believe that a close relation and familiarity with the client will reduce the quality of the audit (Anson 2003; Clapman 2003; Imhoff 2003). A new auditor will have a new/fresh point of view. A close relationship might have the consequence that auditors become less rigorous because they trust their client and rely too much on previously done work. Supporters also believe mandatory rotation of the audit firm increases competition between auditors in the market because they would have to compete to get the client who has to switch audit firm. However, the supporters of mandatory audit firm rotation rules mostly base their claims upon opinion rather then actual research (ICAEW 2002).

Opponents logically do not agree with the abovementioned arguments. Opponents argue that the quality of the audits is low in the first few years of engagement. The highest quality of
audits is made after the initial few years of the audit engagement because the auditor will need time to develop specific knowledge about the company.

A relatively old study by Pierre and Anderson dating from 1984 can give some insight on the audit quality matter. In their case study, Pierre and Anderson analysed lawsuits between auditors and clients during a period of thirteen years (1960-1973) (Pierre and Anderson 1984). This study was not conducted to study mandatory audit firm rotation rules and its effect on audit quality; however some relevant conclusions can be used for the sake of this thesis. One of the things Pierre and Anderson observe is that risks of error increases in the first few years of a new audit engagement (Pierre and Anderson 1984). This is also supported by research done by Walker, Lewis and Casterella whose aim was to find the connection between the duration of the audit tenure and audit quality (main focus was on audit failure). They used a complex mathematical model (logit model) to predict audit failure (Walker, Lewis and Casterella 2001). The outcome of this model was that the risk of failure is higher in the initial phase of an auditor and client relationship, and declines over a longer period of time (Walker, Lewis and Casterella 2001). Instead of declining, audit quality improves over time (Cameran et al. 2006). Walker et al. also note that audit failure still occurs relatively much in long-term audit relationship, however short-term relationships have a higher rate of failure (Walker, Lewis and Casterella 2001). Because of this fact mandatory audit firm rotation might not be the best way forward. Besides outright audit failure, fraud is also more likely to occur in a short-term audit relationship. There is a positive relationship between a short-term audit relationship and the amount of fraud in the financial reports, the same is never proven for long-term audit relationships (Carcello and Nagy 2004). This is another fact that shows that mandatory audit firm rotation can have a negative effect on the audit quality. As was also mentioned in the auditor independence part of the thesis, auditors are generally more dependant and influenced by their clients in the first few years of the audit engagement, this of course also influences the quality of the audit (Geiger and Raghunandan 2002). Meyers et al. conducted a study on the relationship between accruals and the length of the audit relationship (Meyers et al. 2003). In their research they could not find any kind of evidence that the audit quality would drop in long-term auditor and client relationships, instead they found some proof that accruals are of a higher quality level in long-term auditor and client

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8 Accounts on a balance sheet that represent liabilities and non-cash-based assets used in accrual-based accounting.
relationships (Meyers et al. 2003). They found out that ‘abnormal accruals are smaller and accruals have more predictive ability’ (Meyers et al. 2003). It is also more likely that unexpected accruals occur in a short-term audit relationship than in a long-term audit relationship. This was concluded in an experiment of Johnson, Khurana and Reynolds where they created a model to observe companies. The results were that the number of unexpected accruals was high in short-term audit relationships when compared with long-term audit relationships (Johnson, Khurana and Reynolds 2002). In the final conclusion they made, they stated that the quality of auditing was lower in short audit tenures and they argued that mandatory audit firm rotation was not a solution to the problem (Johnson, Khurana and Reynolds 2002). This is supported by Johnson et al. who claim that audit quality is lower in the first three years of the audit engagement because of more and bigger irregular accruals (Johnson et al. 2002). The abovementioned points might all be arguments against mandatory audit firm rotation. It is safe to say there is a close relationship between audit quality and audit tenure. However, there are academics who believe that mandatory audit firm rotation might improve the audit quality. Based on their own research Copley and Douchet conclude that the longer the auditor and client relationship lasts the more the likelihood of low quality audits increases (Copley and Douchet 1993). Others as was shown contradict this finding as they conclude that long-term audit tenure does not have a negative effect on audit quality (Myers, Myers and Omer 2003).

Literature on the topic shows that different views on the topic of audit quality and mandatory audit firm rotation exist. The great majority of the academic studies argue that mandatory audit firm rotation has a negative effect on the quality of the audit, while a few academics believe it will increase audit quality. This thesis supports the view that mandatory audit firm rotation will have a negative influence on the quality of the audits. Because of periodic rotation a completely new situation will be created every time in which the newly appointed auditor is (relatively) unfamiliar with the activities and controls of the client. This limits the ability of the auditor to perform its duties properly. A study conducted in the United States analyzed 406 alleged defects and failures in the audit control in the period between 1979 and 1991 (AICPA 1992). They conclude that mistakes mostly occur when the auditor lacks client specific knowledge and experience. When auditors lack knowledge and experience they will have to heavily rely on estimations and claims of the client (Roos 2004). Research shows that this reliance decreases in the later stages of the audit relationship between the auditor and the client (Myers 2002). A research by the SDA Univerista Bocconi
shows that the auditor gains ‘deep knowledge’ of its client after three years, this is when the audits become of high quality (SDA Univerista Bocconi 2002). After the sixth year the audit quality will again slightly increase but not as much as in the third year (SDA Univerista Bocconi 2002). Audit firms (especially the Big Four) that want to provide audits of a high quality level will be negatively affected by mandatory audit firm rotation rules when they occur in short intervals. And as shown by the abovementioned study by the SDA Univerista Bocconi even mandatory audit firm rotation with longer intervals can damage audit quality.

This thesis believes that mandatory internal auditor rotation is more suitable than its external variant. With internal rotation the auditor will also change and the new auditor will also have a ‘fresh’ look. The big advantage is that client specific knowledge will not be lost and this will ultimately be beneficial for the audit quality. Another issue related to client specific knowledge is that business nowadays is becoming more and more complex because of factors like size, technology, geographical spread and business structure (ICAEW 2002). This means that auditors need more time to fully understand a business and its operations. This is an even greater problem in specialized industries. In these sectors the auditors need detailed knowledge to be able to identify critical areas of high audit risk (ICAEW 2002).

Mandatory audit firm rotation can also create the so-called horizon problem. In an audit market with mandatory audit firm rotation, the auditors know beforehand that the audit relationship will end after a certain period of time. This given fact might take away or create new incentives for auditors when performing their audit tasks (Gosh and Moon 2005). The way of accounting is believed to be motivated by incentives (Magee and Tseng 1990). When the audit tenure only exists for a limited amount of time and the end date is known to the auditor, the quality of the audit will reduce over time (Cameran et al. 2006). The worst quality of audits will be in the periods nearing the ending period of the audit tenure (Cameran et al. 2006). Since the audit tenure cannot be extended because of the mandatory audit firm rotation regime, auditors will have fewer incentives to use maximum effort in their auditing (of course they still have the incentive of reputation). The idea behind mandatory audit firm rotation is to increase audit quality, the argument of the horizon problems shows that a mandatory rotation regime is more likely to reduce audit quality. Investors (the capital market) will also notice an increase in costs. Investors will not be able to distinguish between voluntary auditor changes caused by opinion shopping and imposed rotation. This will raise their information costs (Bigus and Zimmermann 2007).
2.3 Costs

When discussing the costs of mandatory audit firm rotation the opponents of mandatory audit firm rotation will argue that the agency benefits will not outweigh the costs, the supporters on the other hand will argue that the agency benefits are worth the costs. The idea behind auditing is that it will reduce agency costs, however the fortune 1000 in the United States believes that the costs of mandatory audit firm rotation are not worth the benefits (Blouin et al. 2005). These costs include risk of audit failure in the first years of switching, auditor selection and support costs and increased audit costs (Blouin et al. 2005) Based on literature the biggest costs for the switching companies are the actual costs of switching and agency costs (Blouin et al. 2005).

Switching costs can be described as ‘the start-up costs companies have when changing to a new auditor’ (Blouin et al. 2005). Agency costs can be described as ‘monitoring expenditures by the principal, bonding expenditures by the agent, and loss in welfare experienced by the principal due to the agent not acting in the principal’s best interest’ (Jensen and Meckling 1976; Watts and Zimmerman 1983). Companies will normally only change audit firm to reduce agency costs or to improve audit quality (Nichols and Smith 1983; De fond 1992).

Mandatory audit firm rotation leads to an increase of total auditing costs (Copeland 2002; Melancon 2002). It will lead to an increase of total costs for both the auditors and companies. It will directly increase the costs of audit firms who will reflect this in their prices which will then also increase the costs of the companies. This is also the reason why the Dutch government initially only wanted to adopt mandatory internal auditor rotation rules (Ministerie van Financiën 2004, article 19). Start-up costs are generated by familiarization with the client’s accounting procedures (Cameran et al. 2005). This is necessary in order to gain good knowledge of the client. As was mentioned before, the knowledge the auditor had with the client over the years will be completely lost with the rotation of the audit firm. Research among European accountant firms shows that their costs increases with 22, 5 percent when they get a new audit client (Roos 2004). If an auditor is appointed in an area which is relatively new (were he is unfamiliar with) to him and his firm, the costs can even increase up to 50 percent (Arruna 1997). In the United States 96 percent of the Tier One Firms stated that their costs in the first year were higher than in the following years (GAO 2003). The clients on their turn have to provide resources for the auditor; they have to provide

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9 List of 1000 largest U.S. public companies based on revenues.
assistance and material resources. The client will spend more time to orient its new audit team. They will also make costs when selecting the new auditor; these are called research costs (GAO 2003). It causes extra costs and takes extra time.

A study by Benito Arrunada and Candido Paz-Ares clearly shows how mandatory audit firm rotation increases the total audit costs. In their study called ‘Mandatory Rotation of Company Auditors: A Critical Examination’ (1997) they use a mathematical formula to predict the increases of costs that mandatory audit firm rotation rules would create. They took a hypothetical company with an indefinite duration that would change its audit firm. They analyze the difference in costs when a company switches its audit firm because of legal requirements instead of switching voluntarily. The results of their research will be explained and can be found in the figure below (figure found in Arrunada and Paz-Ares 1997):

![Graph showing the increase of audit costs](image)

**Fig. 1. Rate of increase of the total audit cost \([TAC_m - TAC_v]/TAC_v\) on the introduction of mandatory rotation, depending on the actual rotation period before (\(r\)) and after (\(\pi\)) the introduction of the rule. In case \((a)\), \(c_a = c_c = 0.75\) \(c_f\); \(c_a = c_c = 0.25\) \(c_f\) in case \((b)\); and \(i = 0.10\) in both cases.**

The figure above shows two scenarios. In both scenario (a) and (b) the \(C_m\) symbol represents the start-up costs of the audit firm and the \(C_c\) symbol represents the costs a company makes when switching its auditor. It has to be noted that the \(C_f\) symbol does not include the possible increase of the audit price when switching audit firm and assumes the new auditor will ask the same price for its audit services. In practice however, it is very likely that the audit price will be higher because audit firms will reflect their higher costs in their audit price. Mandatory audit firm rotation is also likely to significantly reduce the amount of ‘lowballing’. In
voluntary audit firm switches, audit firms will offer their services for a low price, in some circumstances even under the market value, in order to try to get the client. This phenomenon is called ‘lowballing’ (Pool 2011). When the switch is periodical and mandatory, audit firms will not make lower offers to get the client. It should however be noted that not everyone sees ‘lowballing’ as a good thing (Pool 2011).

In both scenarios the $rr$ symbol stands for the mandatory audit firm rotation rule while the number represents the amount of years after which the switch has to be made. The $i$ symbol is the appropriate discount rate used in both scenarios. The two graphs are based on opposite extreme scenarios; scenario (a) assumes very high switching costs while scenario (b) assumes very low switching costs. The horizontal line shows the number of years before the company voluntarily changes its audit firm. The vertical line shows the increase of costs in percentages. The figure shows how much more a mandatory switch of audit firm would cost (in percentages) when compared with a voluntary switch. It takes the normal number of years, ranging from 10 to 40, before a company would voluntarily switch its auditor, and looks how much more costly it would be if a mandatory audit firm rotation regime would be adopted. To clarify the figures two examples will be given. In scenario (a) for example, the costs would be around 50% higher if the mandatory rotation should take place after three years and the company would normally switch after forty years. In scenario (b) the costs would be around 7.5 percent higher if the mandatory rotation should take place after six years and the company would normally switch twenty years.

Based on the study conducted by Benito Arrunada and Candido Paz-Ares some conclusions about audit costs can be made. First of all the research shows that the shorter the mandatory switching period is, the higher the audit costs will be. It also shows that the costs will be higher if the company estimated to switch over a longer period of time (for example 40 years) regardless of the mandatory switching period.

As was already mentioned before, there is an increased risk of audit failure in the first few years of working with a new auditor (Palmrose 1991; Myers et al. 2003). Companies logically want to keep the costs related to switching as low as possible. Mandatory audit firm rotation is cost inefficient. An alternative to an external regime can again be an internal regime. Internal switching will also increase costs but significantly less then external rotation because knowledge gathered over the years will still be in the possession of audit firm (Roos 2004).
2.4 Competition

It is also important to analyse what kind of effect mandatory audit firm rotation will have on the competition on the market for audits. The mandatory audit firm rotation rule will have an effect on the audit market. It could improve or distort competition on the audit market. Supporters of the rule believe that the audit market is too concentrated and that mandatory audit firm rotation will increase the competition on the audit market. Also between the Big Four audit firms and the smaller audit firms. This thesis will look at the effect mandatory audit firm rotation will have on the competition in the audit market.

PricewaterhouseCoopers, Deloitte Touche Tohmatsu, Ernst & Young and KPMG are the biggest audit firms and are commonly referred to as the Big Four (Economist 2004). Before the Enron scandal, the earlier mentioned Arthur Andersen was also a part of the biggest audit firms (‘Big Five’). The Big Four audit firms are dominant in the international audit market and control most of the market shares. This dominance of the Big Four is a topic of debate and some authors and institutions voice their concern over the formed oligopoly on the audit market (Caramanis 2002; Gibbs 2011). This is not desirable from a competition point of view. Instead of increasing competition on the audit market, mandatory audit firm rotation would decrease the competition on the audit market. Mandatory audit firm rotation would increase the dominance of the Big Four because the choice when switching is limited. Mandatory audit firm rotation limits the number of appropriate audit providers in the market of complex and cross-border audits. Companies who, because of their activities, require a highly specialised audit firm will be limited in their freedom of choose because not every audit firm possesses the required knowledge to audit a specialised company (Roos 2004). This also conflicts with the contractual freedom of both the client and the accountant. The supporters of mandatory audit firm rotation believe that the rule would create an opportunity for smaller firms to provide audit services to the bigger public listed companies. However, some of the bigger public companies are known to have rules in their statutes that require them to be audited by one of the Big Four. This means that the bigger companies would still rotate between the Big Four audit firms, this would still not increase the competition on the market.

A research between 1995 and 1998 on the Dutch market showed that almost every branch in the Dutch industry uses a specialised audit firm (Meuwissen 2002). Because the market is only getting more and more complex this number is nowadays most likely even higher. Small audit firms do not have the capital or expertise to compete with the Big Four audit firms.
There are no incentives for small firms to invest in themselves because even if they acquire the right to audit a company they know they can only audit them for a limited period after which they will lose the firm again. In a normal market economy, without the mandatory audit firm rotation rule, companies will have incentives to invest in themselves because it will enable them to attract more clients and in turn increase their income. If legislation is adopted that forces auditors to leave a client after a number of years, this will take away all the incentives of the audit firm. The absence of long term commitment takes away the incentives of auditors on two points. First of all auditors will not invest in new audit technologies (Arrunada and Paz-Ares 1995). Second of all they will not invest in employees who have to perform the audit (Arrunada and Paz-Ares 1995). It will also have an effect on the quality of the audits. Only the Big Four really operate everywhere in the world, most other accountant firms do not operate on a world wide level. This would again cause trouble for firms when changing audit firm.

Because of the fact that there are only a few audit firms that can audit the larger public companies, mandatory audit firm rotation would not solve the problem of market concentration. The lack of audit firms is a big limitation for audit firm rotation. The Big Four are in control of the majority of the audit market because of the capital they posses, their expertise and the reputation they have. Mandatory audit firm rotation also limits the possibility for some companies to freely choose an audit firm. Mandatory audit firm rotation is not sufficient to increase the competition on the audit market. Mandatory audit firm rotation is seen by its supporters as a way to encourage competition in the audit market. The supporters of the rule believe that audit markets are uncompetitive because the market is concentrated and the switching costs too high. Mandatory audit firm rotation is supposed to solves these issues. However, mandatory audit firm rotation or any other changes in the accounting regulation are not capable of solving these problems. The solution for market concentration should instead be sought in anti-trust (competition) rules (Cameran et al. 2006). Researches also note that mandatory audit firm rotation increases the likelihood of collusion between audit firms (especially the Big Four audit firms) with the aim of coordinating the acquisition of clients (Cameran et al. 2005). Using this method the Big Four audit firms will just re-divide the audit market among them self.

The advantages and disadvantages of mandatory audit firm rotation have been described in this chapter. The figure below summarises the most important advantages and the
disadvantages of external mandatory audit firm rotation and mandatory internal auditor rotation.

<table>
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<tr>
<th>Small overview of internal and external rotation</th>
<th>Mandatory internal auditor rotation</th>
<th>Mandatory audit firm rotation</th>
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<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td>• a new and ‘fresh’ look</td>
<td>• A new and ‘fresh’ look</td>
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<td></td>
<td>• Preservation of client specific knowledge</td>
<td>• Creates a positive view of accountants for the public</td>
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<td></td>
<td>• The preservation of the freedom of choose</td>
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<tr>
<td><strong>Disadvantages</strong></td>
<td>• Increase of costs</td>
<td>• Risk of abuse (opinion shopping)</td>
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<tr>
<td></td>
<td>• Outside of the public view</td>
<td>• Decrease of audit quality</td>
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<td></td>
<td></td>
<td>• Significant increase of costs</td>
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<td></td>
<td></td>
<td>• Freedom of choice is limited</td>
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<td></td>
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<td>• Not enough audit firms to make it effective</td>
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3. The United States and Enron

The earlier mentioned Enron and WorldCom scandals in the United States caused the demise of audit firm Arthur Andersen. Long-term audit relationships can result in a problematic degree of closeness between the management of the client and the auditor. Arthur Andersen was the long-term audit firm of Enron and the following statement by a former Enron employee can be used as a good example: ‘Andersen auditors and consultants were given permanent office space at Enron headquarters here and dressed business-casual like their Enron colleagues. They shared in office birthdays, frequented lunchtime parties in a nearby park and weekend fund-raisers for charities. They even went on Enron employees’ ski trips to Beaver Creek, Colo. “[P]eople just thought they were Enron employees,” says Kevin Jolly, a former Enron employee who worked in the accounting department. “They walked and talked
the same way ... It was like Arthur Andersen had people on the inside ... the lines become very fuzzy’ (Herrick and Barrionuevo 2002).

The Arthur Andersen example can be used to analyse mandatory audit firm rotation because companies were forced to switch audit firm because of the demise of Arthur Andersen. Of course this switch was made out of necessity and not because of legal requirements; nonetheless it can be used as a good comparison to look at the effects of such a switch because the Arthur Andersen setting after the financial scandals in the United States can also be seen as ‘mandatory’ auditor rotation. All the former Arthur Andersen clients had to switch their auditor. This setting can be used to analyze whether the forced change of audit firm is beneficial for companies or not. This ‘simulation’ is especially useful for analysing the effect the switching has on the audit quality and audit costs.

In the United States Blouin et al. and Nagy conducted individual research on the effects of mandatory audit firm rotation (Blouin et al. 2005; Nagy 2005). They took advantage of the unique and rare situation that was created after the collapse of Enron and Arthur Andersen. It should be noted that they acknowledge that the research was done in an artificial scenario and that the results might not be completely the same in a real mandatory audit firm situation. This can for example be made up from a statement by Nagy who states that, ‘it is performed under a quasi mandatory change environment that differs from a true mandatory auditor change environment’ (Nagy 2005). Blouin et al. mainly focused on the effect that mandatory audit firm rotation would have on audit costs by analysing the factors that play a role in selecting a new audit firm, while Nagy mainly focussed on the audit quality (Blouin et al. 2005; Nagy 2005).

The most important factors that play a role in picking a new audit firm are switching costs and agency costs (Blouin et al. 2005). Companies balance those costs with each other when determining which audit firm they should pick. Blouin et al. found out that ‘aggressive’ companies (companies with an accounting financial expert on their audit committee and companies in an industry dominated by Arthur Andersen) chose to follow their former Arthur Andersen auditor. This would suggest that those companies preferred low switching costs over the risk of high agency costs that could occur by following the former Arthur Andersen auditor. They state that companies that followed their former Arthur Andersen auditor ‘curbed their aggressive accrual behavior in the year after Arthur Andersen collapsed while there was no change for those that did not follow Arthur Andersen’ (Blouin et al. 2005). They saw this
as a proof that mandatory audit firm rotation does not improve financial reporting (Blouin et al. 2005).

In the end Blouin et al. conclude that companies searching for a new audit firm balance the tradeoffs between agency costs and switching costs. They argue that a mandatory audit firm rotation regime would not necessarily improve audit quality (Blouin et al. 2005).

Nagy believes that mandatory audit firm rotation would have a positive effect on the audits done by smaller sized audit firms (Nagy 2005). However, he also states that additional research is needed in this field which could indicate that he is not completely sure about his finding. The study is most likely also influence by the state of the audit market during that period of time. This research was conducted shortly after the Enron (and WorldCom) crisis. Auditors could ill afford another misstep and were most likely more alert and sceptical. Nagy could not find the same positive results for larger audit firms, meaning that their audits would not be of a higher quality but also not lower. Switching audit firm is costly, thus if it does not increase the quality of the audits it is not worth the high costs.

4. Mandatory audit firm rotation in Europe

4.1 European experience

The European continent has some degree of experience with the mandatory audit firm rotation rule. Nowadays there is only one country with mandatory rotation rules, that country is Italy. Because there are only a limited few countries (and only one European Union member state) that currently have a mandatory audit firm rotation regime, there is a shortage of actual empirical data (Cameran et al. 2006). The situation in Italy however, can be pre-eminently used to analyze the effects of mandatory audit firm rotation. Italy has had long experience with mandatory audit firm rotation (since 1974). The other countries that currently have mandatory audit firm rotation rules (mentioned in chapter two) can also be used as a valuable example, however the experience those countries have is more limited since those rules have only been adopted around the 1990s. Those countries are also not on the European market and their audit market might be completely different then the European one (no actual research was done on the Asian or Latin American audit market).

In the (recent) past some European Union member states such as Austria, Spain and Greece had mandatory audit firm rotation rules but those rules are no longer applicable (Velte &
Nonetheless, those countries can be used as a good example because they have had actual experience with a mandatory audit firm regime. There experience with mandatory audit firm rotation is relatively short, however those countries are all a part of the European market. It might therefore be interesting to examine why all three of those countries dropped the mandatory audit firm rotation rule. The most plausible explanation is that the legislators were not satisfied with the results or the market reacted in a negative manner.

In this chapter the Italian experience with mandatory audit firm rotation will be used as a case study. All the four critical points that were mentioned in chapter two will be analysed in the Italian context. These points are: auditor independence, audit quality, audit costs and competition on the audit market. How these four points were influenced by the mandatory audit firm regime can give a good insight of the advantages and disadvantages of mandatory audit firm rotation. The Parmalat case that has been mentioned a couple of times will also be analysed. It happened within the Italian market and as could be read in one of the previous chapters this was one of the biggest corporate scandals in history (Ferrarini and Giudici 2006).

It is good to look at what went wrong and why rules of mandatory audit firm rotation could contribute in discovering or even preventing this scandal. Before looking at the Italian market, the Spanish audit market will be studied. Spain, like Austria and Greece, has had some brief experience with mandatory audit firm rotation. The effects that mandatory audit firm rotation had on the Spanish market during that brief period can be analysed and the reason why the legislation was abolished after only a few years will be discussed. Spain was chosen because sufficient data from research is available for the Spanish market, while this is less for Austria and Greece (Arrunada & Paz-Ares 1995; Arrunada & Paz-Ares 1997; Gomez-Aguilar et al. 2006). Mandatory audit firm rotation has a few months ago (February 14, 2012) also been adopted in the Netherlands. However, this experience is too short to provide any relevant information and will thus not be included in this thesis.

4.2 Spain

Mandatory audit firm rotation was adopted in Spanish law in 1988 and required companies to switch their audit firm every nine year. The law was changed in 1995 and the mandatory audit firm rotation rule was dropped (Gomez-Aguilar et al. 2006). This means that the law was dropped before the first mandatory change. The reason for abolishing the rule was that mandatory audit firm rotation had a negative effect on the quality of the work of auditors in
Spain; this also disturbed the structure of the audit market (Arrunada & Paz-Ares 1997; ICAEW 2002). According to Gomez-Aguilar et al. the removal of the mandatory audit firm rotation rule was seen by many as a ‘rational decision’ because ‘the rotation rule did not work and did not achieve its objectives of public policy’ (Gomez-Aguilar et al. 2006). They also wonder whether or not mandatory audit firm rotation has had a fair chance (Gomez-Aguilar et al. 2006). They might have a point as the mandatory audit firm rotation rule was dropped before any Spanish company had to switch its audit firm. However, all the companies in Spain knew that audit firm rotation was mandatory in Spain and they acted in accordance to that. The existence of such legislation must have influenced the behaviour of the auditors. According to Ruiz-Barbadillo et al. ‘auditors’ economic incentives and reporting decisions were conditioned by, and subject to, the existence of mandatory rotation’ (Ruiz-Barbadillo et al. 2006). Therefore the Spanish experience with mandatory audit firm rotation can provide evidence of the positive and negative aspects of mandatory audit firm rotation.

As was discussed in some detail in chapter two, the supporters of mandatory audit firm rotation believe that a long-term auditor and client relationship will have a negative effect on the quality of the audits. Mandatory audit firm rotation would make auditors more independent because it takes away (or reduces) the incentive to issue biased audit reports and reduce the risk of collusion. Mandatory audit firm rotation would contribute in discovering fraud and misconduct more often. Ruiz-Barbadillo et al. conducted a study of the Spanish audit market between 1988 and 1994 in which they mainly focused on the effects that mandatory audit firm rotation rules had on the independence of auditors (Ruiz-Barbadillo et al. 2006). The topics of audit quality and costs were of course also discussed. In their study called ‘does mandatory audit firm rotation enhance auditor independence? Evidence from Spain’, Ruiz-Barbadillo et al. cannot find any proof that mandatory audit firm rotation increases auditor independence (Ruiz-Barbadillo et al. 2006). As we know the main idea behind mandatory audit firm rotation is that it improves auditor independence, a more independent auditor would discover more fraud or other misconduct within a company. If this theorem is true it would also mean that auditors would issue more ‘qualified’ and ‘going-concern’ opinions (Ruiz-Barbadillo et al. 2006). A going-concern opinion is a negative sign for a company because it indicates that the auditor believes that the company can no longer remain in business. However, Ruiz-Barbadillo et al. discovered that there was no increase in the number of going-concern opinions, and that this number was higher in the period after 1995 when rotation is no longer mandatory (Ruiz-Barbadillo et al. 2006). Ruiz-Barbadillo et
al. can be quoted saying, ‘we find that reputation concerns create incentives for independence. Such incentives appear to have a greater impact on auditors’ reporting behaviour in a regime without mandatory rotation than in a regime with rotation of audit firms’ (Ruiz-Barbadillo et al. 2006). The results of the Spanish experience with mandatory audit firm rotation are in line with the results of chapter two. Mandatory audit firm rotation does not necessarily increase auditor independence while it decreases audit quality. It is unnecessary as good alternatives exist and the market should provide enough incentive to stay independent (Ruiz-Barbadillo et al. 2006).

4.3 Italy

It was already mentioned that Italy is the only country in the European Union that has a mandatory audit firm rotation regime, this regime has been in effect since 1974 (Cameran et al. 2005). As we know a company in Italy has to switch its auditor every nine years (Auditors are appointed for three years but can be re-elected two times) to be in line with Italian law (Benedetto and di Castri 2005). Most of studies on mandatory audit firm rotation, including the ones used in this thesis, are either based on voluntary rotation, simulation of mandatory rotation, calculation based on mathematical formula or estimations/predictions. All those results are really valuable because they provide good knowledge and insight on the matter and can be used to form an opinion on mandatory audit firm rotation. However, the Italian experience is the best setting to study the effects of mandatory audit firm rotation. It is the ideal situation that can be used in order to analyse the actual effects that mandatory audit firm rotation has on auditing for both company and auditor. Mandatory audit firm rotation has been in effect for 38 years in Italy, long enough to have gathered insight on the effects of the mandatory rotation regime.

The Italian SDA Bocconi School of Management conducted a study on the impact of mandatory audit firm rotation in Italy (SDA Bocconi School of Management 2002). The outcome of their study was generally in line with the results of all the studies analysed in chapter two of this thesis. In their final conclusion the academics from the SDA Bocconi School of Management stated that the policy of mandatory audit firm rotation had ‘lead to additional cost, greater concentration of work amongst the largest audit firms and negative impact on audit quality that is most noticeably in the years immediately after the rotation’ (SDA Bocconi School of Management 2002; Cameran et al. 2005). Some interesting
behaviour can be found in the Italian audit market. First of all, a significant majority of Italian companies seems to keep their auditor for the maximum legally allowed period of nine years before they switch to a new auditor. Auditors seem to serve their maximum allowed tenure even though auditors are elected for three years and can optionally be re-elected twice for the same period of time (three years) (SDA Bocconi School of Management 2002). This information can be understood as the fact that companies would also not change their auditor after the period of nine years and would like to continue with the same audit firm. It also shows that companies do not want to switch auditors after a relatively short period of time.

The second interesting point is the fact that most ‘qualified audit opinions’ are published after three years of the audit relationship (SDA Bocconi School of Management 2002). Qualified opinions are negative for a company; it suggests there is something wrong with the audit, for example it can indicate that the client company did not provide complete information or did not act in line with proper accounting principles (Chow and Rice 1982). A qualified opinion is a written statement in the audit. The fact that most of these qualified statements are made after three years suggest that three years is the time that auditors need to gain full knowledge of the business of the client. Interviews and surveys conducted under managers of Italian companies and auditors showed that they experienced a reduction of audit quality because of mandatory audit firm rotation. This happened because auditors had too little insight of the company during the first few years of an audit engagement (SDA Bocconi School of Management 2002). The final interesting point is the fact that most auditors are fired during the first year of the audit engagement (SDA Bocconi School of Management 2002). Audit firm switches do not occur very frequently, however when they occur it happens in the first year. This fact can again support that audits are of a low quality in the first few years of the audit engagement. The experiences on the Italian audit market also support that the cost of auditing increases for both the audit firm and the client company (SDA Bocconi School of Management 2002). Especially an increase of start-up costs has been found.

Another point that the European Commission really stressed in their proposal was that mandatory audit firm rotation would open up the audit market, increase competition and decrease market concentration (European Commission 2011). In chapter two of this thesis it was shown that most academics claim the opposite. Based on their studies it can be concluded that mandatory audit firm rotation only increases the concentration on the audit market. It is interesting to analyse what kind of effect mandatory audit firm rotation has had on the competition on the Italian audit market. Like is the case in many countries, the Big Four audit firms (before the Enron scandal Arthur Andersen was also a part of the biggest audit firms in
Italy) have the biggest market share in Italy and most of the public listed companies are being audited by them. This indicates that companies (public listed) just switch between one of the Big Four audit firms every nine years. 38 years after the adoption of mandatory audit firm rotation in Italy, the audit market is still highly concentrated. Like the case in many countries (bigger) listed companies will always want to be audited by the Big Four audit firms. The concentration is so high that one can say that there are only four audit firms that compete for the right to audit a public company in Italy. Research in the Italian audit market has shown that ‘market shares are not stable in the market segment where audit rotation firm is not mandatory’ and ‘market shares are stable in the segment where the rotation rule is enforced’ (SDA Bocconi School of Management 2002). This again indicates that there is more competition within the audit market when there are no mandatory audit firm rotation rules.

The only positive effect that the academics of SDA Bocconi School of Management could find was that mandatory audit firm rotation indeed creates the perception, and makes the public (third parties) believe that auditors are more independent (SDA Bocconi School of Management 2002). This outcome was based on interviews and questionnaires conducted with managers of companies and auditors.

Even though Italy has mandatory audit firm rotation rules, the Parmalat scandal that came shortly after the big American scandals could not be prevented. Parmalat was an Italian company (based in Parma) founded by Calisto Tanzi that was active in the food industry. It was established in the 1960s as a dairy company and over the years it expanded to other types of food and even other industries such as the television market (Ferrarini and Paolo 2006). Parmalat was a big international player who at its peak had a value equal to 0,8 percent of the Italian GDP (Benedetto and di Castri 2005). In the end it in December of the year 2003 it collapsed because of high debt and big losses (Melis 2005). The management of Parmalat acknowledged that holes existed within their financial statement. Billions of euro’s had been missing from the accounts of the company (Melis 2005). The Parmalat scandal had a great effect on the Italian capital market. The scandal lead to the collapse of the Italian bonds market (Ferrarini and Paolo 2006). The problem in the Parmalat scandal was a typical continental European problem. In continental European governance structures, controlling shareholders are sometimes able to exploit the company instead of monitoring the managers (Ferrarini and Paolo 2006). These kinds of scenarios are undesirable and create governance problems. The problem in the Parmalat scandal was different then in the Enron scandal. The governance structure with Parmelat was clearly deficient while it was well designed with
Enron (Ferrarini and Giudici 2006). Besides the failure of the audit market, the auditors also failed to detect the fraudulent conduct within Parmalat. According to Ferrarini and Paolo the capital market in Italy ‘discounted the perceived risk and heavily relied on gatekeepers’ (Ferrarini and Giudici 2006). The audit firms of Parmalat, Grand Thornton International and Deloitte Touche Tohmatsu, were not able to (or unwilling to) detect the fraud within the company. According to Coffee it is ‘clear that Parmalat is another tale of the corporate governance deficiencies of undeterred gatekeepers’ (Coffee 2002; Coffee 2004). The author mentions the word ‘gatekeepers’, which can be described as ‘outside professionals who provide verification or certification services to investors’ (Coffee 2004). Auditors can be seen as the most important class of gatekeepers (Ferrarini and Giudici 2006). The Italian capital market put a lot of trust in the gatekeepers (mostly auditors) because they believed they had enough incentives not participate with and prevent fraud or other misconduct. Auditors have little to gain and much too loose; they would only receive a small percentage of the profit made out of fraud, while they could lose their entire reputation and as a consequence they could loose everything (think about the Enron example). In theory auditors are able to independently and honestly audit their clients. They cannot afford to destroy their reputation while companies cannot easily drop their auditor if they are not willing to participate in the fraud. Companies cannot do this because, like we had already analysed in one of the previous chapters, switching auditors is very costly and the capital markets react to it as this usually indicates problems within a company.

Audit firms in Italy are appointed in the shareholders meeting. The board of statutory auditors has some influence over the selection of the audit firm however the final decision is made in the shareholders meeting (Melis 2005). Grant Thomton International audited Parmalat in the period between 1990 and 1998. After this period it had to comply with Italian law and switch audit firm. In the year 1999 Deloitte Touche Tohmatsu was appointed as the primary auditor of Parmalat (Ferrarini and Giudici 2006; Melis 2005). This switch did not bring the fraudulent conduct to the light. Deloitte Touche Tohmatsu did not see any problems with the financial situation of Parmalat and did thus not report anything negative in their financial reports (Ferrarini and Giudici 2006; Melis 2005). On October 31, 2003 Deloitte Touche Tohmatsu published a review report on the financial situation of Parmalat. In this review report they stated ‘to be unable to verify the carrying value of Parmalat’s investment’ (Melis 2005). They reported that 49 percent of all assets came from Parmalat’s subsidiaries while 30 percent of the consolidated revenues also came form the subsidiaries of Parmalat (Melis 2005). The
problem was that some of these subsidiaries had different auditors (Ferrarini and Giudici 2006). During that period of time there was a visible trend that the number of assets and consolidated revenues in the subsidiaries kept growing over the years. This could have been a warning sign for the auditors. The figure below is based on data collected in a study by Andrea Melis in which she studied corporate governance failures on the Italian market. On its turn the data she used was collected from various reports published from 1999 to 2002. The data can be found in the figure below, it compares the total assets and consolidated revenues in percentages audited by the primary auditor and the other auditors (figure is found in Melis 2005).

<table>
<thead>
<tr>
<th></th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets of the group non audited by the chief auditor</td>
<td>22%</td>
<td>40%</td>
<td>42%</td>
<td>49%</td>
</tr>
<tr>
<td>Total assets of the group audited by the chief auditor</td>
<td>78%</td>
<td>60%</td>
<td>58%</td>
<td>51%</td>
</tr>
<tr>
<td>Consolidated revenues non audited by the chief auditor</td>
<td>16%</td>
<td>23%</td>
<td>23%</td>
<td>30%</td>
</tr>
<tr>
<td>Consolidated revenues audited by the chief auditor</td>
<td>84%</td>
<td>77%</td>
<td>77%</td>
<td>70%</td>
</tr>
</tbody>
</table>


In the case of Italy and Parmalat, mandatory audit firm rotation did not achieve the intended results (increasing auditor independence and audit quality) and was thus not really successful. Grant Thornton International for example still acted as the secondary auditor of Parmalat by auditing several subsidiaries such as Bonlat that was used to hide all the fraudulent conduct (Ferrarini and Giudici 2006). Deloitte Touche Tohmatsu heavily relied on the audits made by Grant Thornton International. In the Parmalat scandal both audit firms can be blamed. First of all, Grant Thornton International lost its independence and was cooperating with Parmalat in the fraud. The Bonlat subsidiary was purely established to hide the misconducts within Parmalat from the new audit firm Deloitte Touche Tohmatsu. However, Deloitte Touche Tohmatsu can also be blamed. Some believe that Deloitte Touche Tohmatsu would have ‘discovered the fraud if they had acted according to general auditing standards and exhibited the proper degree of professional ‘scepticism’ in executing their audit procedures’ (Melis 2005). They should have known that the only purpose of the subsidiaries was to be used in so-called creative accounting. It was established for financial reporting purposed and not business ones (Palepu and Healy 2003). In the case of the Parmalat scandal the auditors, among others, failed despite of mandatory audit firm rotations. The auditors were either not
compétent (Deloitte Touche Tohmatsu) in performing their tasks or not independent (Grant Thornton International) (Palepu and Healy 2003).

The Italian situation that was analysed in this thesis provided a unique opportunity to study the effects of mandatory audit firm rotation. It is the only country in the European Union with mandatory audit firm rotation rules and the only country in the world that has that many years of experience with it. The Italian experience, just as the Spanish experience, is in line with the outcome of all the research discussed in chapter two of the thesis. In Italy mandatory audit firm rotation has had a positive effect on the perceived independence of the auditors. But the positive effects are limited to this outside appearance of independence. Mandatory audit firm rotation has lowered the quality of audits in Italy, raised the costs and ensured that the market is even more concentrated than it was before. Besides that, one of the greatest corporate scandals took place in Italy, despite of the mandatory audit firm rotation regime. Incentives such as reputation are still regarded as the biggest incentives for auditors to perform their work correctly. Thus more regulation might not be the solution. In Italy there was also not enough enforcement of the legislation (under enforcement) (Ferrarini and Giudici 2006). According to Ferrarini and Giudici this problem is not a typical Italian problem but is seen everywhere in continental Europe (Ferrarini and Giudici 2006). This might be another reason why more legislation might not be the solution and the solution should be sought in other alternatives.

5. Discussion

In this chapter the results of the two case studies (Spain and Italy) and the various academic studies that had been analysed will be discussed. These studies proved to be very useful in forming a good opinion on the benefits and drawbacks of the possible adoption of a mandatory audit firm rotation regime in Europe. Especially the Italian and Spanish experience has proven to be really valuable as it clearly showed that mandatory audit firm rotation does not achieve the intended results of increasing audit quality and increasing the competition on the audit market. All other non-empirical studies are generally also in line with this finding. Only a few academics seem to support mandatory audit firm rotation. This thesis supports the majority view and believes that the benefits of mandatory audit firm rotation do not outweigh
the costs. Because mandatory audit firm rotation has more disadvantages than advantages, alternative options should be sought. Therefore, in this thesis some alternatives will be sought and recommendations will be made.

The auditor has to prevent that he loses his independence in a long-term audit relation. There are three types of rotation forms that can all contribute in enchanting auditor independents that were also mentioned in the thesis. These three are mandatory external rotation, mandatory internal rotation and natural rotation. Even though evidence is not strong there is some evidence that mandatory audit firm rotation improves auditor independence, at least in appearance. Mandatory audit firm rotation may be a solution for the short-term because it might in the first years of a new audit engagement relieve auditors of pressure carried out by the management of the client company. More importantly it increases the perceived independence of auditors. Therefore, the sub-title of the thesis is named ‘a cure or a placebo’.

In light of all the overwhelming evidence it seems more like a placebo as mandatory audit firm rotation does not solve any problems on the audit market. Instead of yielding to gut feelings, better alternatives should be sought to achieve the aims put forward by the European Commission. Improving the mandatory internal rotation regime could be a solution. It was shown that internal rotation is more effective, if not, just as effective as external rotation. A quick overview of the advantages and disadvantages of internal and external rotation can be found in the figure in chapter 2.4. This thesis supports the view that internal rotation has more advantages than external rotation. It was also shown that natural changes happen within audit firms and client companies. Natural changes do not always occur therefore one cannot assume that it happens however it is also a factor that has to be taken into account as it also helps preserving auditor independence. If one wants to rotate its auditor the internal variation should always be preferred above external rotation. Research, both empirical as other types of research, shows that external audit firm rotation lowers the quality of the audits. It was also shown that mandatory audit firm rotation increases the costs of both the audit firm and the client company. This increase of costs cannot be justified if audit quality is only lowered. Again, internal rotation can be a good alternative because the new auditor will also have a ‘fresh’ look while all the negative side effects of mandatory external rotation will be avoided.

One of the spearheads of the European Commission was the aim to increase the competition on the audit market. Because there are only four big firms (Big Four) mandatory audit firm rotation will not be effective. Mandatory audit firm rotation alone will not be sufficient to achieve the level of auditor independence the European commissions aims for.
Besides mandatory internal auditor rotation, other alternatives to mandatory external audit firm rotation exist. Some alternatives that have been put forward by some auditors are ‘*further increasing the audit committee monitoring of the auditor's objectivity and scepticism*’, better training for auditors and more transparency (PWC 2012). These suggestions are useful and might contribute in achieving the goals set by the European Commission. However, the alternatives of joint audits and more accountability for auditors should also be considered as the first one could potentially open up the audit market by increasing competition and increasing audit quality while the latter could increase auditor independence.

In this thesis it is supported that audit quality should eventually be the main point of reform as the quality of the audits is the most important in the end. If more audit firms would enter into the audit market, it is believed that this would increase opinion shopping (Gibbs et al. 2011). Gibbs et al. believe that this risk can be prevented by mandating joint audits (Gibbs et al. 2011). In a joint audit system the Big Four audit firms would cooperate with medium sized audit firms in conducting audits (Gibss et al. 2011). The idea behind joint audits is that it would increase competition on the audit market while at the same time improving the quality of the audits. It is also believes this to be true as two firms working on one audit might ‘*increase objectivity and professional scepticism of the auditors and thereby increasing audit quality*’ (Gibss et al. 2011). One big disadvantage might be that joint audits will probably increase the costs of auditing.

Auditors work for their client as they pay them, however they also have a public responsibility. Some believe that ‘*Auditing firms can be considered to be part of our economic infrastructure*’ (Gibbs et al. 2011). Our economy and our capital markets are based upon a system of trust. Gibbs et al. believe that the biggest problem regarding auditor independence is the fact that there is an ‘*industry-wide lack of commitment to objectivity and professional scepticism*’ (Gibss et al. 2011). Again, mandatory external rotation of the audit firm alone will not improve the independence of auditors while independence plays a crucial role in the audit process. This means that mechanism should be created to hold auditors more liable for their actions. Auditor accountability is not sufficiently regulated on the European market, while American auditors can be held accountable for their actions more often (Ferrarini and Giudici 2006). The accountability system in Europe should be improved. This thesis is not an advocate of criminal sanctions like is the case in the United States.
Accountability should stay limited to fines and other disciplinary sanctions. Criminal sanctions should only be considered in the most extreme situations.

6 Conclusion

In this thesis the advantages and disadvantages of a system of mandatory audit firm rotation was analysed in the light of the proposal made by the European Commission. This proposal was launched by the Commission in November 2011 who among other measures, proposed legislation regarding the introduction of mandatory audit firm rotation for all the European Union member states. The effects that mandatory audit firm rotation would have on the European audit market have been analyzed in this thesis. And thus the question this thesis tries to answer was the following:

*Should the introduction of a system of mandatory audit firm rotation as proposed by the European Commission be implemented in the European Union?*

In order to answer that question, various academic literature, experiments and the Spanish and Italian experience with mandatory audit firm was studied. Based on those gathered results a conclusion on the desirability of mandatory audit firm rotation will be made in this chapter.

It was noted that mandatory audit firm rotation has in the past been a hot topic of debate among academics and legislators. However, it was never adopted on a large scale. Only five of the Twenty-four analysed countries had legislation mandating audit firm rotation. It was interesting to see that legislators in the United States, a country which has experienced large scale corporate scandals, refused to adopt mandatory audit firm rotation rules. This recently re-surfaced topic is relatively old and plenty of academic literature is available and was used to analyse mandatory audit firm rotation. The literature used gave a good insight on mandatory audit firm rotation. It was noted that most of the available studies were either based on voluntary rotation, simulation of mandatory rotation, calculations based on mathematical formulas or estimations/predictions. In order to compensate this, Italy and Spain were used as a case study. Both Spain and Italy have experience with mandatory audit firm rotation. Spain had a mandatory audit firm rotation regime from 1988 to 1995. Italy still has a system of mandatory audit firm rotation that has been active since 1974. Italy provided a unique setting because no other country has had more then thirty years of experience with
mandatory audit firm rotation. The effect that mandatory audit firm rotation would have on the audit market was divided into four different topics. These topics were auditor independence, audit quality, audit costs and audit market competition. The effects of mandatory audit firm rotation were approached from various perspectives. In chapter two an approach reviewing a broad sample of academic literature available on this topic was studied. In chapter three the collapse of Arthur Andersen was used in order to create a simulation of a mandatory audit firm rotation regime. This, despite some limitations also gave a good insight on mandatory audit firm rotation. In the forth chapter an approach based on actual empirical data was taken in order to analyse the effects of mandatory audit firm rotation. In general all research indicates that mandatory audit firm rotation has a negative effect on all four analysed topics. Therefore it must be concluded that mandatory audit firm rotation has counterproductive effects.

Considering all research used in this thesis it can be concluded that mandatory audit firm rotation certainly increases audit costs, decreases audit quality and reduces competition in the audit market. One of the main goals the European Commission wanted to achieve was to increase the competition on the audit market. This cannot be achieved with mandatory audit firm rotation as such legislation changes the pattern of competition on the market which increases the risk of collusion among the bigger audit firms. It was shown that such legislation would take away the incentive from smaller audit firms to invest in themselves because they cannot compete with the bigger firms because of the periodical changes.

From the four studied topics audit quality is the most important one. The lower the audit quality will be the higher the probability of fraud will be. Because mandatory audit firm rotation decreases audit quality it cannot be justified. Closely linked to audit quality is auditor independence. We had shown that mandatory rotation of the audit firm might not solve the independence issue. As was shown in the European case study on Italy it does not necessarily increase the willingness of auditors to report. The costs of audit firms and companies also increases, this can never be justified because mandatory audit firm rotation does not solve the problems in the two crucial points of audit quality and competition on the audit market. Even if mandatory audit firm rotation would reduce the costs of auditing it could still not be justified because it reduces the quality of audits and lowers competition on the audit market. Suppose that mandatory audit firm rotation would increase the three other analyzed points the increase in costs could be justifiable as, form a public interest point of view, this is the least important one of the analyzed points. Of course companies will never like the increase of their
costs, however if it would improve the audit market it may well be worth it. Unfortunately this is not the case with mandatory audit firm rotation. The only positive that could be found point of mandatory audit firm rotation that could be found is fact that the public (third parties) regard the auditors to be more independent. Mandatory audit firm rotation thus creates the appearance of independence. The relevant question one should ask is whether this appearance of independence is worth more than actual independence and audit quality. This thesis will argue that it is not. This thesis showed that auditor independence, audit quality, audit costs and completion on the audit market would all be negatively affected by the introduction of a mandatory audit firm regime. The alternatives of internal rotation, joint audits and increased liability had been recommended. The abovementioned clearly shows that mandatory audit firm rotation would have no added value and should therefore not be adopted by the European Union. Mandatory audit firm rotation will not be a ‘cure’ for solving the problems on the audit market. It can at most serve as a ‘placebo’ to satisfy public reactions.
References


