



# **The effects of mandatory audit firm rotation on the Finnish auditing environment**

From Finnish auditing professionals' perspective

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<p>Sammandrag:</p> <p>Syftet med denna studie är att utvärdera effekterna av EU kommissionens beslut att införa obligatorisk rotation av revisionsbyråer. Tidigare forskning har inte kunnat bevisa huruvida sådan lagstiftning faktiskt effektivt stärker revisorernas självständighet. Denna studie undersöker därför ifall EU kommissionens mål har uppnåtts utan att försämra kvaliteten av revisorernas arbete. EU kommissionens mål innefattar förhöjt förtroende i finansiell information, förstärkning av revisorers självständighet och skepsis, samt en mer dynamisk revisionsmarknad. Andra effekter av obligatorisk rotation som undersöks är hur stora kostnader en sådan lagstiftning för med sig. I arbetet har en kvalitativ forskningsmetod använts med fokus på individens föreståelse ur en konstruktivistisk position. Datasamlingsmetoden var tre semi-strukturerade intervjuer med revisorer från tre av de fyra stora revisionsbyråerna. Intervjuförfrågningar skickades ut via e-post till alla revisorer med CGR-certifikat som jobbar för en av de stora revisionsbyråerna i Helsingforsområdet. Totalt skickades över 200 förfrågningar ut under en period på två månader och tre accepterade förfrågningar kom tillbaka. Alla intervjuer transkriberades ordagrant för att bevara så mycket nyanser som möjligt. Transkriptionerna analyserades med hjälp av teoretisk tematisk analys och kodades med sju förbestämda teman som grund. Dessa koder kategoriserades under respektive teman och analyserades samt omformulerades för att bättre motsvara de intervjuades åsikter och tankegångar. Resultatet visar att finländska revisorer inte lider av något allmänt bristande förtroende. Majoriteten av de intervjuade var positivt inställda till lagstiftningen. Obligatorisk rotation av revisionsbyråer var alla överens om att kan ha en positiv inverkan på revisorernas självständighet, även om det inte har förekommit några problem. Någon slutsats om huruvida kvaliteten har påverkats positivt eller negativt kunde därför inte dras. Den uppskattade kostnadsökningen uppgick till cirka 20% och några stora strukturella förändringar på revisionsmarknaden var inte troliga. Därför kunde det konstateras att EU kommissionen har uppnått sitt mål genom att man bibehållit förtroendet i finländska revisorers arbete, men eftersom denna studie är tämligen subjektiv lämnas den slutgiltiga slutsatsen till läsaren.</p>	
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<p>Abstract:</p> <p>The aim of this study is to assess the effects of Mandatory Audit Firm Rotation in Finland as a means of restoring confidence in financial statements. Given the inconclusive evidence of its effectiveness towards increasing auditor independence and professional scepticism while also having the possibility of decreasing audit quality, this thesis evaluates the outcome versus the European Commission's objectives for the European audit reform. Other effects evaluated in the thesis related to the topic are audit costs and the audit market. The conflicting theories regarding limiting audit firm tenure either claim that auditor independence is improved by reducing excessive familiarity, or that it is insignificant with high probability of decreasing audit quality and increasing costs. The methods used in this thesis was qualitative from a constructionist position and with an interpretive approach. The empirical research was conducted by interviewing three Big Four auditors from different firms. The interviews were semi-structured and transcribed verbatim. The results indicated that Finnish auditors already retain an elevated level of confidence among stakeholders and little improvement is expected on that front. The results further showed that Mandatory Audit Firm Rotation could potentially enhance auditor independence and professional scepticism, whereas the effects on audit quality are inconclusive. The cost increase was approximated to 20% while upcoming changes in the audit market were regarded relatively small. The overall attitude towards the reform was mostly positive. As the nature of this thesis is subjective, only an interpretation whether the European Commission has achieved their goals with the reform is provided by the author, instead of a definite answer which is left for the reader to decide.</p>	
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# 1 INTRODUCTION

With over 10 years since the financial crisis of 2007 and its consequences, the distrust of the capitalistic global markets is still looming. As regulators are being more and more concerned of a repeat crisis, pressure is put on the independence aspect of auditors and the quality of their work to avoid such an event from happening again. (Ewelt-Knauer et al. 2013)

According to the framework published by the International Auditing and Assurance Board (IAASB), the purpose of an audit is to enhance the degree of confidence of intended users in a company's financial statements. The board states that since a lot of an auditor's work is based on judgment, it necessitates not only integrity, but also objectivity and scepticism alike. When an audit is concluded, it states the auditor's opinion, that the financial statements at hand give a "true and fair value" of the company and is without "material misstatements". (IAASB, 2013).

As there is limited insight in how the audit is conducted and what the findings are, the confidence in the auditor to remain independent is fundamental to the whole world's capital markets. Without this confidence, the audit loses its value and there is no verification that a company's financial statements are in fact "true".

## 1.1 Background

In 2001 after the Enron scandal when the US Commission drafted the Sarbanes-Oxley Act (SOX), they considered mandatory audit firm rotation, i.e. a system where companies would be forced to rotate their statutory auditor periodically, as an instrument to limit audit firm tenure and enhance independence (Jackson et al. 2008). As they did not reach a consensus, the US Government Accountability Office (GAO) was tasked in investigating the potential effects such legislation would have on audit quality. They concluded in 2003 after rigorous objections not least from audit firms, that several years' worth of experience with the newly adopted SOX was necessary before any additional measures

to enhance auditor independence and audit quality can be taken (Jenkins and Vermeer, 2013).

Since then, the European Commission (EC) has issued new reforms concerning the whole of Europe regarding new auditing practices and prohibition of certain activities (European Commission, 2016). This reform is a response stemming from a green paper sent out in 2010 after the financial crisis, where stakeholders and accounting professionals could share their views on a range of issues regarding the financial market.

The conclusions drawn from 2010's green paper was that there are doubts amongst investors on the reliability and credibility of financial institutions' financial statements, as well as excessive familiarity between the management and the auditing body (European Commission, 2011). As a measure to reduce this excess familiarity and restore the confidence in financial information, the EC decided in 2014 to include mandatory audit firm rotation (MAFR) in their audit reform, in an attempt to increase transparency, independence, and supervision. The legislation came into effect 17<sup>th</sup> of July 2016 across Europe.

## **1.2 Problem formulation**

As the theory chapter illustrates, research on MAFR and its effects is controversial to say the least. In general, there are two schools of thought.

First, proponents that claim MAFR will help prevent auditors from becoming too familiar with management, which in turn would benefit their professional scepticism and independence. Further, advocates of MAFR argue that for some auditors, certain clients are of such importance, that a loss of that client would significantly influence the profitability and revenue stream of the auditing firm (Hoyle, 1978).

Secondly, opponents of MAFR claim that rotations would lead to a lower audit quality, because of the loss of client-specific knowledge when the company is forced to rotate audit firms (Knapp, 1991). Knapp also argues that because of the steep learning curve of auditors, audit failure would be even more prevalent in the first years of a rotation, as the auditor needs sufficient time to familiarize himself with the company's operations.

Moreover, the US GAO report from 2003 also estimated an increase in additional auditor selection costs among companies equal to 17% of their first-year audit fees, as well as an increase in audit cost overall brought on by the additional workload of MAFR.

A 17% increase in audit fees for a Finnish listed company, e.g. Stora Enso, would result in an increase of 850 000€, as their audit fees already amount to 5 million euros (Stora Enso, 2018).

As MAFR now has been implemented in all EU countries, it can now be questioned whether the regulation has been successful in reaching its objectives of ensuring auditor independence and professional scepticism, without decreasing the audit quality.

### **1.3 Scope and demarcations**

This thesis will only cover the mandatory audit firm rotation effects on Finnish auditing firms, brought by the EU Directive 2014/56 and Regulation No 537/2014. Other elements of the reform are not taken into consideration, for the research to be sufficiently specific. Therefore, the prohibition on non-auditing services and the strengthening of the audit committee which are the two other major changes with this reform, falls beyond the scope of this thesis.

Another limitation is that even though MAFR was implemented in 2016 with the European Audit Reform (EAR), because of the EC's decision to avoid a "cliff-edge" effect any company which have had a lengthy engagement with an audit firm get a transitional period. This means that the majority of the forced rotations in Finland are happening after 2020.

Moreover, the MAFR requirement only refers to Public-Interest Entities (PIE), and therefore only affects those audit firms with such clients. This puts a limitation on the number of both companies and auditing firms affected, as the number of auditing firms conducting statutory audits is few in the Finnish business environment. In turn, this limits the applicable research methods, since the number of auditors and comparable experts is therefore lower.



## 1.4 Research aim, questions, and relevance

The aim of this thesis is to evaluate whether the European Audit Reform has reached its objectives regarding auditor independence and professional scepticism with the implementation of MAFR in Finland, and whether the audit quality has suffered as a result. Therefore, the main research questions this thesis attempt to answer is the following:

- **Has the EU, according to Finnish Big Four auditing professionals, reached their intended goals of increased auditor independence and professional scepticism with the implementation of Mandatory Audit Firm Rotation without negatively affecting audit quality?**

Moreover, additional secondary research questions have been developed to further investigate the effects of the reform:

- **Has MAFR brought a significant cost increase for the affected parties?**
- **Has the EAR affected the dynamics of the European audit market?**

To the author's best knowledge, similar research has not been conducted in Finland after the reform has been implemented. Predictions on the effects of the reform have however been conducted in countries with similar business culture, e.g. Sweden (Eriksson and Erland, 2016). Thus, the relevance of this study lies in the originality and novelty of the research.

## 1.5 Disposition

At the start of the thesis, the reader was presented with a background which led to the problem statement and research questions. At the end of the introduction a list of all abbreviations used can be found, followed by the literature chapter which explains the relevant theories regarding the topic. The theory chapter is constructed in such a way, that the reader is first presented with the field-specific terms and concepts, to later assist in the review of MAFR and the EAR.

The chosen research methods are presented along with the material used, ethical considerations, data collection, and analysis method in the subsequent chapter.

In the empirical parts, the results of the data collected are presented along with an analysis of the results. The thesis ends with a discussion and final conclusions, as well as suggestions for further research.

## **1.6 Abbreviations**

IAASB = International Auditing and Assurance Board

GAO = US Government Accountability Office

SOX = Sarbanes–Oxley Act

EC = European Commission

MAFR = Mandatory Audit Firm Rotation

EAR = European Audit Reform

PIE = Public-Interest Entity

ISB = Independence Standards Board

PS = Professional Scepticism

PCAOB = Public Company Accounting Oversight Board

CEAOB = Committee of European Auditing Oversight Bodies

NAS = Non-Audit Services

## **2 THEORY**

In this chapter the most relevant theories and definitions are presented, starting with specific auditor-related terms and finishing with an overview of what MAFR is and the legislative changes the EAR brought.

### **2.1 Auditor independence and PS**

According to the EC framework from 2002 on statutory auditors' independence, the fundamental principles of an auditor should be "objectivity and "professional integrity". If the statutory auditor is not seen as independent, e.g. from management pressure or other, then the audit loses all its value and becomes obsolete (Beattie and Fearnley, 2002).

Therefore, auditor independence is of utmost importance when discussing the EAR and MAFR.

As independent behaviour is largely unobservable, the concept of auditor independence has proven difficult to define precisely (Beattie and Fearney, 2002). There are however multiple representative definitions from various researchers and institutions.

DeAngelo (1981 p. 186) defines auditor independence as “the conditional probability of reporting a discovered breach”.

The Independence Standards Board (ISB) has given the following description; “*Threats to auditor independence are sources of potential bias that may compromise, or may reasonably be expected to compromise, an auditor’s ability to make unbiased audit decisions.*” (ISB, 2000 p. 6).

What both of these representative definitions, as well as most other similar definitions have in common is that they reflect the importance of *objectivity* and *integrity*, here meaning the “*ability to suppress biases*” and “*willingness to express an opinion that truthfully reflects the evaluation of what has been discovered during the audit*” (Beattie & Fearney, 2002 p. 4).

It is also important to distinguish auditor independence in fact and in appearance, as they call for distinctive research approaches (Church et al. 2015). Auditor independence *in fact* is simply described by Beattie and Fearney (2002 p. 16) as “*independent behaviour*”, and independence *in appearance* as “*the belief that auditors are independent*”, the difference here being that ‘in fact’ is almost impossible to observe, whereas ‘in appearance’ is based on the observer’s perception.

As a generally accepted truth based on the various bodies’ definitions of the concept, one can recognise that auditor independence is not, and cannot be an absolute standard (Beattie and Fearney, 2002).

### **2.1.1 Audit tenure and independence risk**

Even though academics have different opinions on how to define auditor independence, there is a substantial body of literature on the subject and its implications.

The ISB discusses five different threats in their independence framework, which are self-interest, self-review, advocacy, familiarity, and intimidation threats. According to them, these threats are all considered to be potential sources of bias and might therefore compromise an auditor's ability to act independently. (ISB, 2000)

However, Nelson (2006) argues that independence in fact is counteracted by incentives for the auditor to act accountable and objectively, and therefore the outputs are appropriate. These incentives include e.g. supervision and reviews, potential lawsuits and regulatory sanctions, and social pressures such as professional ethics requirements and reputational pressures.

Church et al. (2015) suggests that according to their archival studies of independence in fact, fee-based incentives and lengthy audit tenure does not necessarily affect auditors' independence, and in turn audit outputs. (Johnson et al. 2002; Myers et al. 2003; Carcello and Nagy 2004). These studies claim that longer audit tenure does not automatically create an adverse effect on audit outputs. In fact, studies conducted by Carcello and Nagy (2004) even suggest while audit tenure does not have an adverse effect on independence, audit quality is lower in the subsequent years following an audit firm transition, because of the steep learning curve and unfamiliarity of the client.

Carcello and Nagy's (2004) findings are however further complicated by a recent study conducted by Chu et al. (2018), who argue that longer audit tenure does not pose an independence threat, as long as the client's overall business environment is solid, i.e. the company is doing well. Yet, when this changes i.e. the company starts to decline, the longer tenure an audit firm has had correlates with a lower audit quality, which would suggest an independence risk (Chu et al. 2018). This is claimed to be because longer audit-client relationships usually gives the company more leeway and flexibility with e.g. earnings management, as the audit firm has certain financial incentives to keeping the client (Knechel et al. 2013).

In other words, the familiarity between audit firms and clients that comes with tenure is harmless and even improves the audit quality, until the general business environment starts to deteriorate. When this happens, the excessive familiarity could compromise the statutory auditor's independence, and consequently the integrity of all audited financial statements. (European Commission, 2011)

However, studies conducted by Daniels and Booker (2011); Gates et al. (2007) find that independence *in appearance* is in fact affected by audit tenure. Gates et al. findings show that the confidence in financial statements went up under firm rotational conditions, while deeming audit partner rotations insufficient in achieving the same results despite presenting evidence of a reform-compliant audit committee and board of directors. They question therefore whether it was the right choice for the US GAO to postpone the implementation of MAFR, since it evidently does enhance investor confidence superior to partner rotational rule.

### **2.1.2 Professional scepticism and objectivity**

Even though we have already established that auditor independence cannot be an absolute standard, it does however influence the ability to exhibit professional scepticism. According to Chiang (2016), auditor independence is a crucial antecedent to Professional Scepticism (PS). The threats to the auditors' independence, e.g. conflicts of interest, excessive familiarity, could reduce the auditors' ability to exercise a sufficiently high level of PS, which is fundamental when making objective judgements.

Chiang (2016) conclude in her conceptual paper that there is a direct link between auditor independence and PS and it is therefore important that both are brought into assessment when discussing new regulatory measures.

Although frequently discussed in the scientific literature, professional scepticism has many working interpretations. It is largely divided into two perspectives; "presumptive doubt" and a "neutral" view.

Firstly, "presumptive doubt", means that "*indicated by auditor judgments and decisions that reflect a heightened assessment of the risk that an assertion is incorrect, conditional on the information available to the auditor.*" This implies that auditors with "presumptive doubt" display higher PS than those who have a "neutral" view on PS, since it in practice means that they need more persuasive evidence to assert that the financial statements are in fact free from "material misstatements". However, it is possible for an auditor to show excessive scepticism under this definition, which would lead to inefficiency and therefore cause the audit to become unnecessarily expensive for the client. (Nelson, 2009 pp. 1-4).

Secondly, the “neutral” view on PS is most commonly referred to as the Public Company Accounting Oversight Board’s (PCAOB) explanation, where PS is “*an attitude that includes a questioning mind and a critical assessment of audit evidence ... The auditor neither assumes that management is dishonest nor assumes unquestioned honesty.*” (Public Company Accounting Oversight Board, 2002). This is consistently referred to as the “objective” perspective, as it requires the auditor to objectively evaluate evidence that both supports and contradicts management’s assertions (Pennington et al. 2017).

### 2.1.3 The Nelson Model

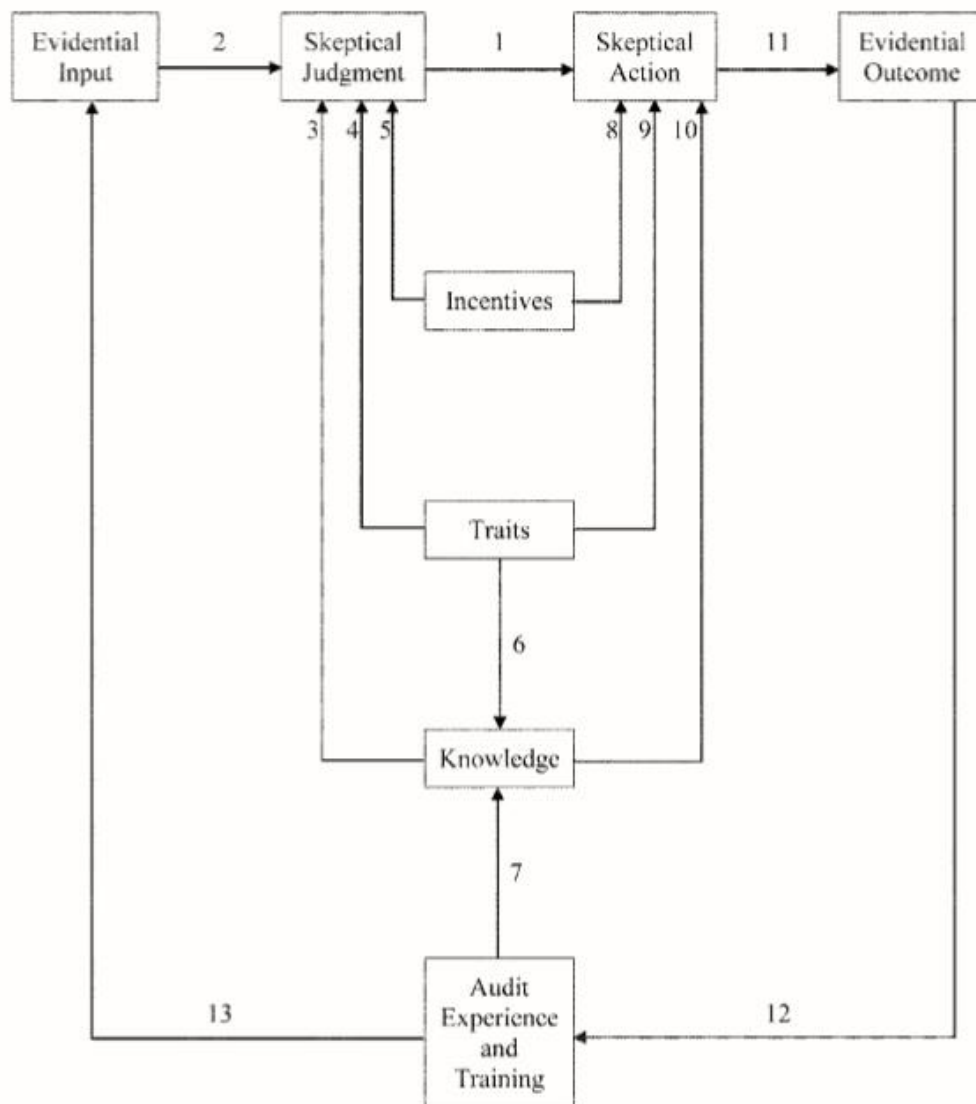


Figure 1 the Nelson Model (Nelson, 2009, p. 5)

In Figure 1 provided above, an overview of the Nelson Model can be seen which divides PS into PS judgement and PS action, as well as gives a broader picture of what PS actually means. The general idea is that “PS is a product of auditors’ judgement, but PS is revealed by sceptical behaviour and therefore an attribute to auditor performance.” (Nelson, 2009 p. 5).

This means that when the auditor is concerned about a potential issue and recognises this as a problem that the auditor can solve with more effort, PS judgement occurs. PS action on the other hand happens when the auditor takes action based on this PS judgement. Since a failure in either one of these would produce a lack of scepticism in either problem recognition or failure to act on a recognised problem, they are both fundamental to the audit process and equally necessary conditions for PS. (Chiang, 2016)

The Nelson Model (Figure 1.) also takes into account other factors, which affects the auditors’ PS such as incentives, traits, and knowledge. The model shows how these are all linked with each other and are explained as separate relationships. The main idea of the model, the difference between sceptical judgement and sceptical action (link 1) has already been explained above.

Evidential input supports the sceptical judgements (link 2) and can be regarded as any information gathered or considered during the audit process. Other factors affecting auditors’ sceptical judgement are knowledge (link 3), traits (link 4), and incentives (link 5). These include attributes such as “intelligence”, “self-confidence”, and “tendency to doubt”. Training and traits also influence an auditors’ knowledge and is represented as link 7 and 6 respectively.

As judgement turns into action, it faces the same influences (incentives, traits, and knowledge) but in a different form. Incentives (link 8) could e.g. be a client pressuring to stay within schedule, traits (link 9) the self-confidence needed to withstand these outside pressures, and knowledge (link 10) the awareness of the time constraints set by the generally accepted accounting principles.

Nelson explains that because the nature of evidence can change based on the actions (link 11), and this later becomes part of the auditors’ experience and knowledge (link 12) which affects the future evidential input (link 13), the model has to be recursive. (Nelson, 2009, pp. 5 - 17)

## 2.2 Audit quality

The scientific literature on audit quality is generally more harmonized than regarding auditor independence. As audit quality cannot be measured during the same fiscal year as the audit, most studies use discretionary accruals or going concern risk as proxy to evaluate the conducted audit's quality in the following year (Tepalagul & Lin, 2015). The problem with the discretionary accrual method is that it measures the degree of accuracy of the accruals before and after the adjustments and can therefore only be done in the subsequent fiscal year.

Firstly, researchers generally agree that longer audit tenure correlates with higher audit quality, since the familiarity with the client's organizational structure aids the auditor to identify possible risks and therefore achieve a higher quality, i.e. less risk of misstatements, higher accruals accuracy. (Cassel et al. 2017)

Cassell et al. (2017) justify this by referring to the phenomena called the "audit learning curve", which they describe as the loss of institutional knowledge as audit firms are forced to rotate. They believe that this "learning curve" is steepest in the first three years for a new auditor but is later flattened out as the auditor gains more insight and knowledge of the company and its operations.

Therefore, according to Cassel et al. (2017) MAFR would lead to a lower quality audit, because it requires the auditor to constantly climb this "steep learning curve" and therefore lead to a reduced audit quality.

Even though the scientific literature has not been able to provide evidence that this learning curve exists, counterarguments can be made that the suggested learning curve should not affect the auditors' quality of work, as the firm should only accept a potential client if they have the required expertise to achieve "reasonable assurance". This means that the audit firm has an implied obligation to turn down potential clients, would the firm not have the necessary resources or capabilities. This derives from the fact the only publicly available data is audit outcome, and not the audit input data e.g. worked hours, personnel experience, number of personnel. It is therefore imperative to be able to forecast whether the firm can ensure, that they will achieve reasonable assurance. (Cassel et al. 2017)



Secondly, studies similar in methodology evaluating auditors' ability to identify going concern risks for bankrupt and non-bankrupt companies were also conducted by Geiger and Raghunandan (2002), and Knechel and Vanstraelen (2007), which proceeded to produce conflicting results. Whereas Geiger and Raghunandan found that in the US, auditors were less likely to issue a going concern opinion during the beginning of an engagement, Knechel and Vanstraelen concluded that in Belgium auditors were neither better nor worse at predicting bankruptcy, irrespective of how long the audit tenure has been.

Lastly, according to Jackson et al. (2008) the results of audit quality varies depending on the methodology used, and therefore when proxied by going concern risk audit quality improves with audit tenure and is unaffected when proxied by discretionary accruals. They argue therefore that there is little benefit in enforcing MAFR, since in a best-case scenario the audit quality stays the same. However, they do point out that the results do not consider improvements in perceived audit quality, and that legislators need to take that into consideration as it may indeed be improved by MAFR.

Interestingly, in a study conducted by Cameran et al. (2016) investigating the audit quality in Italy where MAFR has already been mandated by legislation for some time, they found that audit quality was higher in the last year of an engagement period. At this time in Italy, the engagement periods were three years at a time, with an option for the auditing firm to get reappointed a maximum of two times, i.e. nine years.

However, the study concluded that in order for the firm to be renewed at the end of the 3-year period, the audit firm had an incentive to lower the audit quality the first two years, to improve the quality of the audit significantly during the last engagement period. This option has later been dropped, and once appointed the audit firm is now kept for the whole nine years. The authors also suggest that this might not apply as well to countries with "stronger legal environments", as the increased litigation risk might cancel out the incentive to compromise audit quality. (Cameran et al. 2016).

The concern about audit quality has been one of most valuable arguments for opponents of MAFR. The EC (2016) has as a means of dealing with this issue implemented a system in their regulation, which requires auditors to provide a handover file with all relevant information about the entity to the incoming auditor. This is done in order to guarantee a

smoother transition between audit firms, as well as trying to minimize the misstatements in the beginning of the audit-client relationship and thus try to flatten out the learning curve as much as possible.

## **2.3 Mandatory audit firm rotation**

Mandatory audit firm rotation is, as explained in the introductory and theory chapter, a highly disputed piece of legislation. The consensus among researchers and audit professionals is that something needs to be done in order to increase the confidence in PIEs' financial statements and ensure auditor independence, both in fact and in appearance, to avoid further corporate collapses. Thus, the discussion is about *what*, not *if*, something should be done.

MAFR is a rotational system of audit firms, where there is maximum period of years that a PIE can have the same statutory audit firm, before rotating (GAO, 2003). As the US implemented the SOX after multiple corporate scandals and crises, MAFR was considered, but ultimately not included in the legislation. The Congress decided that MAFR and its potential effects needed more research and tasked the GAO to further investigate whether its benefits exceeds its costs, and whether it would sufficiently restore the confidence in financial information. (GAO, 2003)

The US GAO concluded in their report from 2003 that the potential positive effects of MAFR are uncertain and difficult to predict while they are “fairly certain” additional costs is to be expected. They were in other words not able to make a definite decision, and therefore chose to only implement audit partner rotation, which most stakeholders believed “sufficiently achieve the intended benefits of mandatory audit firm rotation.” This decision was amongst others based on other countries' experience with both MAFR and audit partner rotation, e.g. Italy, Brazil, and the United Kingdom. (GAO, 2003).

In a nutshell, MAFR forces PIEs to rotate audit firms at least every 10 years, with a cooling off period of four years. There is however a possibility to extend the engagement for another 10 years when a public retendering is conducted, or an additional 14 years if a joint audit is adopted. An overview of the different options a PIE has can be seen in Figure 2 provided below. It also includes a possibility for individual member countries to extend

an engagement upon request from the audited entity, for another two years on “an exceptional basis”. (EU Regulation No 537/2014 article 17)

Core requirements	Member State options	
a. 10-year audit firm rotation for all public interest entities (PIEs) in the EU	i. To extend the period once for up to a maximum further:	<ul style="list-style-type: none"> <li>• 10 years if a tender is undertaken</li> <li>• 14 years if joint audit is adopted</li> </ul>
	ii. To adopt a shorter term of rotation	
b. At the request of the audited entity, the national regulators/supervisory authorities can extend the term once for a further two years, in ‘ <i>exceptional circumstances</i> ’. The definition of this remains unclear but is understood to include mergers or where a tender process has been unsuccessful.		

Figure 2 Core requirements for MAFR (Pwc, 2015)

According to Dattin (2017 p. 48), there are four problem-areas to discuss with regards to MAFR; “the eagerness to please the client, long audit tenure, closeness to management, and the audit market.” She points out how the inclination “to please the client is the strongest argument in favour for mandatory rotation.” Because of the lack of transparency in the audit profession, the need for client retention can compromise the integrity of the audit, and thus widen the “expectation gap”, i.e. the discrepancy between the public perceptions of what the auditor’s responsibilities are versus what they believe their responsible are.

Due to this financial incentive issue, i.e. the audit firm aspire to retain the client for as long as possible, audit firms are more prone to accept a higher level of earnings management than on a rotating system. Studies on this have shown that auditors are “less cooperative” under mandatory rotation and tolerates clients’ accounting manipulation to a lower degree, than on a voluntary rotation system. (Ewelt-Knauer et al. 2013)

### 2.3.1 Proponents

Generally, advocates of MAFR claim that it would augment auditor objectivity by limiting audit tenure, and thereby reduce the independence risk of excessive familiarity. It would also provide a different and fresh look at things, which could be in both investors’ and regulatory bodies’ best interests. This in turn would lead to a higher audit quality and

enhance auditor independence. (Bronson et al. 2016; Harris & Whisenant, 2012; European Commission, 2016).

Another argument for MAFR by academics is that the cost of another corporate collapse such as Enron, WorldCom, and Sunbeam far outweigh the increased cost in auditing expenses, and if additional regulatory measures can prevent such an event it is the most reasonable course of action (Jackson et al. 2008).

Finally, MAFR is believed to aid small- or medium-sized auditing firms in achieving larger market share and dilute the Big Four concentration at the top, since new market opportunities would arise from the forced rotation and consequently create a more dynamic market. (European Commission, 2016)

### **2.3.2 Opponents**

Opponents of MAFR on the other hand tend to argue that by forcing auditors to constantly change clients, they are put in a disadvantageous position and is compelled to climb the “learning curve” at a regular basis. This would again lead to the audit quality suffering and an increase in audit costs, as more resources and management would need to be involved in the statutory audit. Additionally, the ban of certain non-auditing services, which is another aspect of the EAR, prohibits the employment of those audit firms who provide these, and in turn reduces the number of potential audit firms even more from the already limited number of firms with the necessary expertise and scale. (Dattin, 2017).

Moreover, according to Wells and Loudder (1997), auditor resignations also give a strong signal to investors and stakeholders about potential conflicts and argues that this valuable indicator would be lost under a mandatory firm rotation system, also commonly referred to as “opinion shopping” (Jackson et al. 2008).

In general, the auditors themselves tend to be against MAFR, not only because of the reasons stated above, but also because of the increased risk of audit failure before auditors manage to gain sufficient “client-specific knowledge” (Ewelt-Knauer et al. 2013).

Solomon et al. (1999) even claim that a longer audit tenure and therefore more client-specific knowledge, allows auditors to become even more independent as they do not have to rely on management as much (Cited in Ewelt-Knauer et al. 2013).

### **2.3.3 Results from Sweden**

As mentioned in the introduction chapter, Eriksson and Erland (2016) conducted a study regarding MAFR and the independence risk of NAS in the Swedish auditing environment, both by questionnaires and interviews.

The results of the Swedish survey were that neither the Swedish auditing firms nor investors were concerned with the new regulation and were sceptical whether the changes would actually make a difference in the market or improve auditor independence. Even though the subjects that answered the questionnaires were more positive than the responses received from the EU's green paper and agreed that lengthy working relationships between auditors and auditees pose an independence threat, the general consensus was that MAFR would not significantly enhance auditor independence.

However, the interviewed auditors did agree on the fact that excessive familiarity could theoretically compromise auditor independence, but none of them could see it happening in the Swedish environment. As they found out that even investors did not evaluate auditor independence in their investment decisions, they predicted that because of the highly ethical business environment in Sweden, there would be limited impact on auditor independence by the new legislation. (Eriksson & Erland, 2016)

## **2.4 EU audit reform**

The EU Audit Reform (EAR) consists of both a Directive and a Regulation, which together form the current rules regarding statutory auditing. The EAR was accepted in 2014 and came into effect July 17<sup>th</sup>, 2016 across Europe after two years to give the member countries enough time to put the necessary provisions in place. (European commission, 2016)

The Directive 2014/56, which amends the Directive 2006/43 sets out the framework for auditors' and audit firms' duties. The Directive also introduces a new European oversight board, the Committee of European Auditing Oversight Bodies (CEAOB), as well as increased requirements for national public oversight regarding the audit profession.

The Regulation on the other hand focuses more on listed companies, banks, and insurance, i.e. public interest entities (PIEs). It specifies the requirements for these PIEs regarding statutory audits and is therefore the focus of this thesis. (European Commission, 2016)

The central purpose of the statutory audit reform is to secure future investment and growth, by restoring the confidence and credibility in financial information in Europe, with the goal of improving the overall audit quality. The intentions are to improve the transparency aspect of financial information, ensure auditor independence and professional scepticism, improve coordination with auditing supervisory bodies, and build up a more dynamic European auditing market. (European commission, 2016)

#### **2.4.1 General measures**

The main elements of the reform are split into two parts, general measures that all audited entities are required to follow, and PIE-specific measures. The general measures are as explained above mostly found in the Directive, and the PIE-specific in the Regulation. The general measures most notably include the strengthened requirements for auditor independence and making the audit report more informative for investors (European commission, 2016).

The independence reinforcement includes strengthening the CEAOB by giving them, as well as national public oversight bodies more authority and investigative powers. The auditors' obligation to keep a record of any independence threats is also stressed and should the safeguard measures to assure auditor independence fail to mitigate these threats, the auditor "should resign or abstain from the audit engagement." (EU Directive 2014/56 article 6)

Making the audit report more informative to investors includes additional information beyond the statement that a company's financial statements give a true and fair view in accordance with the applicable financial reporting standards. This information consists of both an audit opinion which state the auditors' opinion and a statement on any material uncertainties in the audit regarding any doubts, that the entity's "ability to continue as a going concern" is at risk. (EU Directive 2014/56 article 28)

## 2.4.2 Public-interest entity-specific measures

The reason PIEs have stricter requirements regarding statutory audits is because the potential consequences of audit failure are much greater for society as a whole, and the benefits are regarded to outweigh the possible additional costs that comes with specific rules. (European Commission, 2016)

The main changes specific to PIEs are firstly the implementation of MAFR. The EC regards audit partner rotation as insufficient and has determined that the statutory auditor is to rotate every 10 years as a maximum, with additional 10 respectively 14 years when retendering or in the case of a joint audit. In order to avoid a “cliff-edge” effect, the EC has also decided to grant extended PIE – statutory audit firm relationships transitional periods, depending on the audit tenure length and engagement commencement date. This means that even though the reform is in effect, e.g. an audit firm – PIE relationship greater than 20 years does not have to rotate before June 2020 when the firm is prohibited from renewing the engagement. (European Commission, 2016; EU Regulation No 537/2014 article 28). An overview of the transitional arrangements can be seen in Figure 3, provided below.

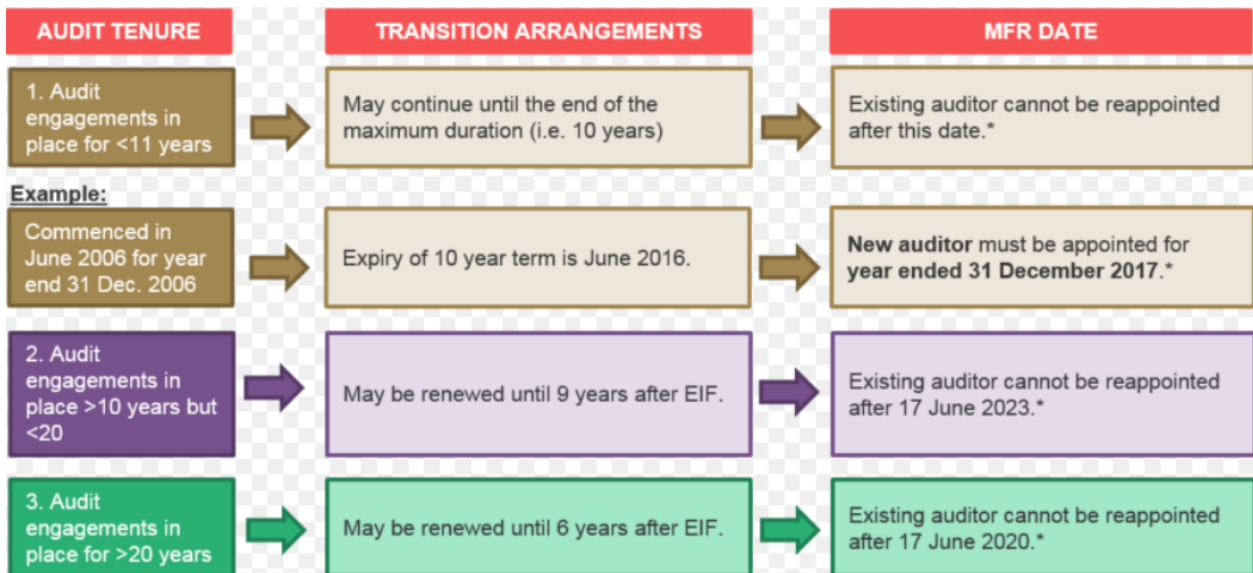


Figure 3 Transitional arrangements for PIEs (EisnerAmper, 2019)

Secondly, the establishment of any contractual clauses that restrict the shareholders' choice, such as the "Big Four Only", are now prohibited for both PIEs and non-PIEs (EU Regulation 537/2014 article 16).

Coupled with the new ban of certain non-audit services (NAS) that prohibits the statutory auditor to both conduct the audit and provide NAS (EU Regulation 537/2014 article 5), the EC believes that this will benefit more mid-tier audit firms as additional market opportunities arise. This is because essentially the number of audit firms are not able to cover all PIEs because of these limitations, thus the statutory audits would therefore have to be conducted by non-Big Four. The objective is to reduce the power and concentration that the top firms have in the statutory audit market, i.e. making the market more dynamic. (European Commission, 2016)

### **3 METHODS**

In this chapter the choice of research methods is presented, along with how the data was collected and the reasoning behind it. Additionally, the chosen material, ethical considerations, and how the data was analysed is also further explained.

#### **3.1 Material**

The previous research used in the theory chapter was obtained using Google Scholar and various scholarly article databases, such as Emerald insight and Sage Journals. A combination of key words relevant to the thesis such as auditor independence, audit tenure, audit quality, and mandatory firm rotation was used to find the most relevant articles and research papers. These well-cited articles and research papers was also used for their reference lists, as many of them referenced to the same researcher(s) and the author was therefore able to pinpoint the leading researcher(s) in that particular area.

#### **3.2 Research method and approach**

As hard as it can be to draw the line between quantitative and qualitative research methods, quantitative methods are in general closely related to numerical results (Bryman &



Bell, 2011). Since this thesis aimed to explain the effects of the implementation of MAFR from auditing professionals' perspective, a quantitative method was not applied to answer the research questions.

On the other hand, a qualitative research method puts more emphasis on words rather than numbers, even though they usually occur in some form. Bryman and Bell (2011) has listed three features that are particularly noteworthy with qualitative methods and useful in this case;

First, an “*inductive view*”, i.e. the theory is generated out of the research, unlike most natural scientific models. Since this thesis' aim was to generate new knowledge and subjectively evaluate a set of goals, and the adopted research approach would not have generated enough conclusive evidence for confirmation of any posed hypothesis, an inductive instead of a deductive view is most applicable (Antwi and Hamza, 2015).

Secondly, *constructivist*, i.e. “the ontological position that suggests social properties are outcomes of social interaction and constructs”. Constructionism differs broadly from the contrasting ontological position *objectivism*, which believes that there is in fact an objective independent reality and was therefore more suitable for achieving the objectives of this thesis (Antwi and Hamza, 2015).

Lastly, *interpretive*, which means that the focus is on the understanding of the social world through an examination of the interpretation of that world by its participants. This paradigm fit the objectives of this thesis, since the interpretive approach tries to understand phenomena through the meanings of the research subjects and interests itself with judging or evaluating existing data or theories instead of generating new ones (Antwi and Hamza, 2015).

Addressing the issue of validity and reliability within e.g. quantitative positivistic research, an interpretivist paradigm is more concerned with trustworthiness and credibility. According to Ulin et al. (2004) these paradigms cannot have the same criteria for credibility, since they have completely different intentions and must therefore reach a sufficient level of trustworthiness in distinct manners. As interpretivism is in its nature subjective, for the research to be considered credible the chosen methodology as well as the processes behind the data collection and analysis should be based on rationality and solid judgement. (Lincoln and Guba, 1985)

Thus, as the objective of this thesis was to get an understanding of the beliefs and opinions of Finnish auditing professionals regarding the EAR and specifically MAFR, the research methodology adopted in this thesis was qualitative. The auditing professionals' perspective was chosen to get a deeper understanding of the problem, as they are the ones affected to the highest degree and have in general been most vocal about the implementation of MAFR, which called for an interpretive epistemological approach. Because this thesis attempted to explain phenomena from the above explained context, the researcher believed a constructionist position was the most appropriate ontological perspective. (Braun and Clarke, 2006).

### **3.3 Data collection**

The data collection in this thesis consisted of 3 in-person interviews with auditing professionals working for 3 different Big Four companies in the Helsinki area.

A set of interviews was deemed the most suitable research method to collect the data, since the research is interested in the auditing professionals' point of view and interested in what they view as important. Thus, the perspective of the professional is in focus.

This research method also gave the interviewee the flexibility to fit in the interview at a suitable time and viewed as less intrusive, since auditors and alike are notoriously busy during the beginning of a fiscal year. (Bryman & Bell, 2011).

A survey which would have been another suitable data collection approach was not seen as a viable option, as similar research in Sweden which sent out questionnaires to auditors showed only a response rate of 6% out of 660 (Eriksson & Erland, 2016). When considering that Finland has even fewer auditors to poll, a response rate of 6% would therefore not yield a statically significant answer and was thus rejected.

The interview invitations were sent out to all Authorized Public Accountants (APA) working for any Big Four company in the Helsinki area. With over 200 email invitations sent out, where about 10% were rejected immediately, the researcher got 1 accepted interview. After multiple reminders, follow-up emails, and business enquiries the researcher got 2 more accepted interviews, ultimately landing on a response rate of approximately 1,5%. The interviews were between 22 – 34 minutes long and were conducted in

the respective interviewee's office building. The interview invitation and interview guide can be found under appendices. The criteria for participating in the research was sufficient knowledge of either the audit profession or the EAR legislation directly, which all the interviewees fulfilled. The respondent's ability to answer the interview questions was evaluated based on either explicit statement of knowledge or being an APA.

### **3.3.1 Sample**

The purposive sample of 3 auditing professionals were decidedly the most suitable candidates to interview, as they are one of the few parties affected heavily of the reform, i.e. one of the key stakeholders. Even though general purposive sample does not allow the researcher to generalize a population, this method gives the researcher the ability to strategically sample the participants, to ensure that those sampled are relevant to the research questions that are being posed (Bryman, 2012). As this thesis is interested in a specific area, they are the ones most likely to have the insights needed for the subject and would therefore give the most informed and accurate answers, which is the main objective in purposive sampling.

### **3.3.2 Interviews**

The interviews were semi-structured, to get rich data which could be compiled and analysed by the author. The semi-structured interview follows a set of questions, which are more specific than the unstructured interview, but the interviewee can answer as they please and no set answers are provided by the researcher.

The semi-structured interview fit the objectives of this thesis, as it gave the researcher an opportunity to ask follow-up questions about particularly significant topics. It also made sure that every interviewee is in general asked the same questions, even though some might not have been in the same sequence. The benefit of a semi-structured interview over an unstructured interview is that the researcher can begin the interview with a clear focus, and thereby address more specific issues (Bryman & Bell, 2011).

Even though semi-structured interviews can also be considered a quantitative research method, the limited number of potential interview subjects makes this troublesome, which

is why the researcher has taken a qualitative approach. An overview over the interviews can be seen in Figure 4, provided below.

Interviewee	Place	Time
Professional Practice Director	Meeting room	22 min
Senior Manager	Meeting room	32 min
Senior Proposal Manager	Conference room	34 min

*Figure 4 Conducted interviews*

The interviews were conducted in English, to spare any translation errors by the researcher. The benefits of this are that the interviews can be fully transcribed without translation and could therefore be interpreted and analysed thoroughly with less risk of misconception. The drawbacks however might be that the participants are not as able to express themselves as eloquent as if the interviews were conducted in their native language and could also have resulted in possible misinterpretations during the interview process. As an underlying basis for the interview-questions were the EU Regulation No 537/2014 documents, as well as Eriksson and Erland's (2016) interview guide. Since their study had both similar goals and methods, and a similarity in audit culture and environment it was compatible with the objectives of this thesis.

### **3.3.3 Response bias**

The researcher was also aware of the type of response bias called social desirability bias, i.e. when interviewees answer what society thinks they should answer and what reflects well on them. As the questions in this thesis are sensitive and could easily reflect badly on the interviewees, this was a major consideration when constructing the questions.

To achieve the lowest possible social desirability bias, the questions were formulated in such a way that the interviewee could easier distance themselves from them, e.g. by asking questions in general, or in third person (Bryman & Bell, 2011). The interviewer also reiterated multiple times that it is the personal opinions of the auditor that is in focus, and therefore reduced the social desirability bias to a marginal amount. A commonly raised concern was that the answers would represent the whole firm but was dealt with by the

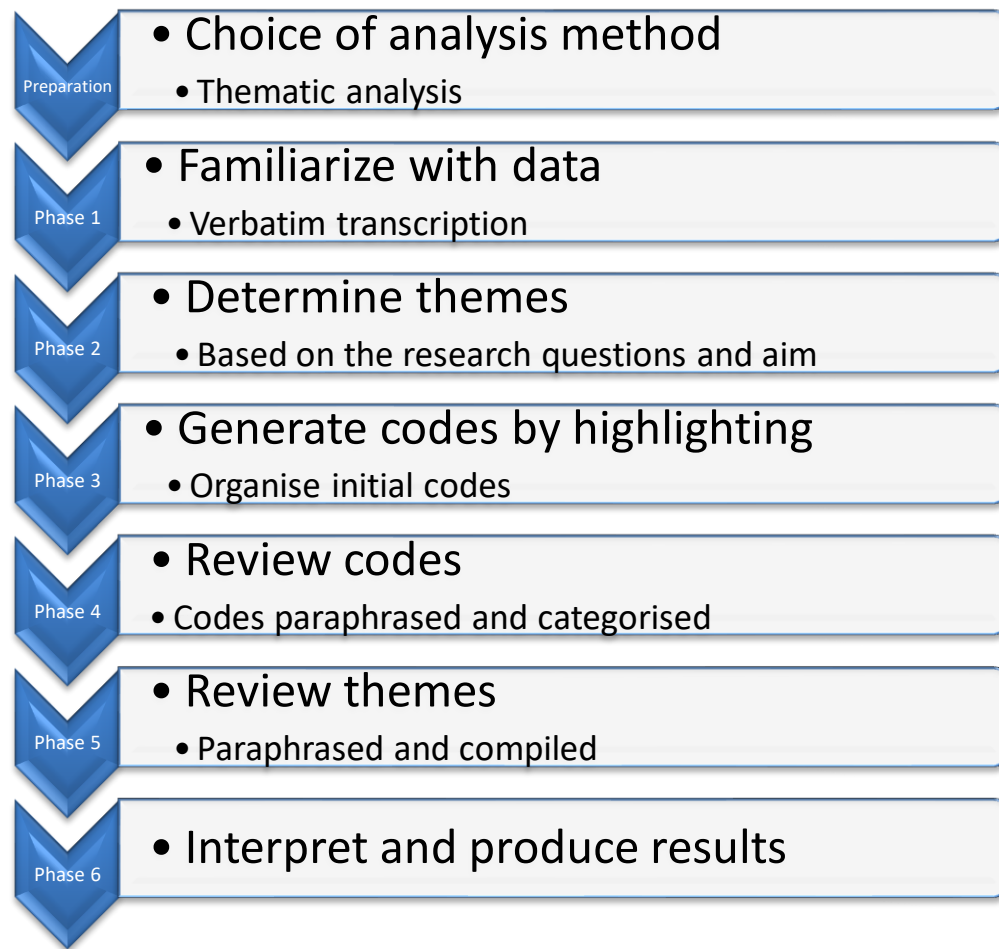
author repeating everything was strictly the interviewee's own opinion and no liability would be put onto the company.

### **3.4 Data analysis**

The data analysis in this thesis consisted of finding the common themes and narratives among the different interviews with the help of theoretical thematic analysis. Seven themes were identified as the relevant topics needed to answer the research questions and can be found in Figure 5 on the next page. The themes were then compiled and compared, to distinguish differences of opinion and general consensus. To be able to conduct a thorough analysis of the gathered data, the interviews were transcribed verbatim, to capture both what and how it was said.

A *latent* or *interpretive* level of thematic analysis, which is also commonly referred to as “thematic discourse analysis”, was deemed to be the most suitable analysis method, since it offers the researcher enough flexibility to efficiently code and categorize the data gathered and provides the opportunity for the researcher to focus on the interpretation and the underlying ideas. A semantic level which would have been the other option, focuses on the explicit meaning of the data without going beyond the surface level, and as this thesis focuses on the underlying ideas of the subjects, it was considered too strict. (Braun and Clarke, 2006). This is based on the presumption that the participants might not have been able to respond as accurately as they might have been able to, given the chance to respond in their native language.

In Figure 5 provided below, a step-by-step guide of how the data analysis was conducted can be seen.



*Figure 5 Data analysis approach*

Firstly, the transcripts were thoroughly reviewed while taking initial notes about thoughts and questions that developed from reading it. This was done after the transcription process to make sure everything was included in the transcript, and no significant details were missing.

Secondly, the transcripts were analysed using theoretical thematic analysis to identify thoughts, opinions and statements that could be compared with each other. The seven different themes that the codes were grounded in were not based on the interview questions, but on relevant predetermined themes relating to the research questions and the associated theory, hence why the researcher has chosen a theoretical instead of an inductive approach to thematic analysis. A theoretical approach assists the researcher answer more specific research questions, as the data can be coded with the existing research questions and themes in mind, rather than letting the themes emerge through the coding process (Braun and Clarke, 2006).

In Figure 6 provided below is an example on how the coding was conducted, and the different themes.



Figure 6 Example of the thematic analysis coding

Thirdly, the codes were categorized using these themes, interpreted and paraphrased to improve the comparability without changing the expressed opinion or statement. These categories were then analysed in contrast to each other and presented in chapter 4.

### 3.5 Ethical considerations

As the research topic in this thesis is delicate, anonymity and confidentiality were of utmost importance. All subjects were informed of the nature of the study beforehand and got the same information before they gave their informed consent to participate. The invitation to participate in the study can as previously stated be found in the appendices section. All the participants were also asked afterwards whether they wanted to review the transcripts before the analysis process, to which one expressed their wish to do so.

Any wishes from research subjects to remain confidential were fulfilled and referred in this thesis to as “Int 1 - 3”, and no identifying details were provided in the thesis. Any recordings of the interviews were only listened to by the researcher in the process of transcribing them and later deleted.

## **4 FINDINGS AND ANALYSIS**

In this chapter the results of the interview analysis are presented under their respective themes. Some of the themes were grouped together to make it easier for the reader to follow the discussion in the following chapter. The chapter follows the same order as the research questions and is structured accordingly.

### **4.1 The standpoint on auditor independence and PS**

Self-interests and a lack of internal controls were reportedly the biggest threats to auditor independence, none of which are an apparent problem in the Finnish auditing environment according to the interviewees. All the interviewees agreed that there is no place for self-interests in the auditing profession, and that it is safely ensured by both internal and external controls. “Since we are only human, there is always a possibility of independence risk, even though it is not an issue in Finland” (Int 2). “Rigorous independence monitoring” (Int 1) and “powerful regulatory bodies” (Int 2) guarantees the independence of Finnish auditors, and “if there’s any, even smaller risk of any issue we will handle it to ensure that there are not any problems” (Int 3). Independence in appearance is an important subject for the Big Four especially, and we look favourable upon increasing it (Int 1).

On the question whether excessive familiarity exists and is a problem, all interviewees agreed that “even though it is a small country and people tend to know each other”, it is not a concern in Finland. One acknowledged that it could “theoretically lead to problems” (Int 1) but considering that the audit engagement leader also rotates every seven years coupled with the Big Four’s internal controls, it is not recognized as a problem. It is worth noting that both Int 2 and 3 expressed doubts whether the US system of partner rotation actually is enough to ensure auditor independence and pointed out that companies tend to



use the same audit firm for “tens and tens of years” which might lead to independence issues.

On the topic whether the EAR and MAFR would increase auditor independence, there were mixed responses. In general, all of the interviewees saw the potential of MAFR increasing auditor independence, but whether it was “a solution without a problem” (Int 3) is unresolved. One interviewee argued that the consequences of many of the new measures will likely lead to increased auditor independence but warned that “there can always come a scandal, and then nobody will remember the EAR anymore” (Int 1). Another one argued that this might have a positive effect in other countries with less supervision, but all the other measures in place would have been sufficient in ensuring independence (Int 2). A third one noted that “some companies in Finland has been audited by the same audit firm for 100 years, and there has never been any issues because of that” but that it might have some positive consequences, “even if it is something we would not like to say” (Int 3).

#### **4.1.1 Professional scepticism**

Both Int 1 and 2 agreed that professional scepticism is “absolutely necessary for auditors”, and it is constantly becoming a more integral part of the profession. The general consensus was that a neutral viewpoint on PS is a preferable one, given that nothing “sparks suspicion” (Int 1). One interviewee recognized the need for presumptive doubt with regards to the valuation methods in the financial sector but even then, a neutral view is the standard procedure (Int 2). Another one pointed out that more and more auditing is done by technology, which would put less emphasis on the viewpoint of a particular auditor since the technology would then recognize irregularities for the auditor to investigate further, and therefore eliminate the process of exercising a particular view of PS (Int 3). The opinions on whether the level of PS will increase with the implementation of MAFR ranged from “it probably won’t make the situation any worse” (Int 1) to “it will increase” (Int 3).

## **4.2 The standpoint on audit quality**

The opinion on whether audit quality suffers because of MAFR widely differentiated between the interviewees. They all agreed that the auditor learning curve is prevalent in the profession, and that auditors are and constantly have to learn new businesses. All of them acknowledged the positive aspects of having a set of “fresh eyes” on an audit, while relying less on previous audits and simultaneously “widening your strengths”, but the opinion on whether the quality ultimately suffers because of rotations were noticeably different.

One claimed that the quality will ultimately increase because of the reasons stated above, since MAFR will not affect the quality in any negative way and therefore eventually improve (Int 1).

Another one claimed that the quality might suffer as a consequence of MAFR, depending on how much resources the firm is willing to spend on a new client, but in general the quality is not affected by the reform. The quality in this case would decrease as a result of not having the necessary expertise of a particular industry or business, and not “recruiting or in some other way handle the situation” to eventually generate an audit team “capable of doing the audit”. (Int 2)

Lastly, Int 3 argued that MAFR will ultimately reduce the audit quality in the early years of a rotation, since the new audit team needs to “get on board on the client’s issues, industry, and way to work” which might take closer to a year for a mid-sized listed company. They also raised the question regarding highly niche companies that might have had the same audit firm for an extensive period of time and will now be forced to switch to an audit firm with no relevant industry knowledge, which brings a “big risk” to the client.

## **4.3 The standpoint on MAFR and the EAR**

The opinion on the EAR varied among the three interviewees, and while most were positively inclined to the reform as a whole, there were some concerns and doubts whether it actually was a necessary addition. Two out of three auditing professionals agreed that when considering what the original draft was, “the outcome is quite good”, especially

since the MAFR element was extended to 10 plus 10 years when a retendering is conducted (Int 1 and 2). One also mentioned the increased transparency in the audit report as a highly beneficial addition to the EAR since you now have to include “key audit matters” and “how you have audited” (Interview 2).

However, the interviewees generally agreed on one negative aspect of the EAR. Their concern was that because it is written “so confusingly”, “difficult to understand both for us and our clients”, and is open to interpretation, it might lead to individual member countries enforcing their own interpretation, “which is something that should not happen”. It also “left so many things for countries to decide” which means that different member countries might have different rules and could potentially complicate e.g. a global audit.

The two APAs’ attitudes towards MAFR were largely positive, without many negative aspects. Since the audit engagement can be extended, it is long enough without promoting an independence issue, whereas limiting the audit tenure to only 10 years would have been too short. Both also pointed out that partner rotational rule is still in effect, which means that the lead auditor cannot stay on longer than seven years, and that it is not uncommon for this to lead to a retendering. One pointed out that the companies tend to dislike rotations due to the fact that it brings “pressure on the audit fees”, even though there is a tendency in the market for the audit prices to go down, which mean “the cost gets eaten by the audit firms” (Int 1). They also indicated that it is “the one’s sitting on the engagements that had had the same auditor always and there had never been pressure to change” were the ones disliking and most sceptical about the implementation. “In general, the audit profession is in favour of increasing the independence in appearance”.

The interviewee who handled proposals (Int 3) was also the most sceptical about the new rotational rules. According to them, MAFR is “a solution without a problem” and is therefore unnecessary. Even though it might have some potential positive impacts on auditor independence, the attitude was that since “there has always been mandatory engagement leader rotations” and there has not been any problems, “it makes things harder for us” but does not bring any meaningful benefit while also “bringing costs, both for the audit firm and the client”. Nevertheless, on the question “whether opinion shopping exists in Finland” they did answer that it might be prevalent here in some cases, “even though it should not be”.

However, the interviewee did acknowledge that perhaps it is not needed in Finland but in other countries, and that it might be the reason behind this decision. “We need to see how this works out in the long run.”

#### **4.3.1 The effects on audit costs**

All the interviewees agreed that an increase in audit costs is highly probable as a result of MAFR, especially because of the higher entry costs during the first years. They were all concerned with the fact that audit firms tend to absorb most of the cost increase, and Int 3 pointed out that it might even in some cases exceed the revenue gained from a client. The cost increase mainly derives from “increased working hours for auditors” and “increased number of tendering processes” and was approximated to 10 – 20 percent for the entry year (Int 2), with 30 – 50 percent more hours spent during the first year (Int 3). “We then need to hope for a minimum of 10 years of engagement to make up for lost revenue” (Int 3).

Moreover, “there has until now been a tendency for fees to go down, which has to stop at some point” (Int 1). As more and more time is put into the audit, “it is not sustainable in the long run”. One interviewee claimed that audit fees also factors in the choice of rotating audit firms, and “by having a tender competition you can get a fee advantage” (Int 2). Another interviewee explained that “the process of winning a new client is quite heavy” and for a bigger tender “we might spend 100s of hours... which we may or may not win” (Int 3).

#### **4.3.2 The effects on the audit market**

The consensus among the interviewees regarding the effects on the audit market was that there will be some changes in the dynamics of the Big Four, but they all had a hard time seeing anyone challenging their position on top. One pointed out how “anyone outside the Big Four may have difficulties in showing the global network and how you make it work” (Int 1), and another one claimed that “bigger companies will still be audited by the Big Fours because of the global strength, which is something our clients are looking for” (Int 3).

However, MAFR could potentially change the dynamics among the top firms, since the biggest companies need to rotate out of their audit firm, and “market share will therefore be gained from the firm with many of the biggest clients” (Interview 2).

When the interviewee from one of the audit firms with stronger presence in Finland responded, they answered: “I am sure it will affect the structure of the audit market, as our strong position has already gone down quite heavily” and “we are going closer and closer to 30% for each Big Four, or maybe Big 3 in Finland, i.e. Ernst & Young, KPMG, and Pwc”.

Moreover, when asked whether the mid-tier firms could potentially grab market share from the Big Fours, one interviewee responded that “there are quite many small companies that could potentially be audited by non-Big Four” and there has been a few companies switching to non-Big Fours in the past two years (Int 3). However, “there are less than ten on the stock exchange” and thus still relatively uncommon, but “it is up to them to show their strengths and capabilities” and “we still need to see if the non-Big Fours are capable of taking an advantage of the situation” (Int 3). One interviewee raised a concern when asked the same question and stated that “supervisory bodies probably do not even want the mid-sized audit firms to have the largest clients” since when you have those clients “you need to have a very high level of internal processes” (Int 2).

#### **4.3.3 Reliability and credibility of the audit profession**

The overall opinion of the interviewees, when asked whether the implementation of MAFR and the EAR would increase the overall reliability and credibility, was that there have not been any legitimate reliability problems in the Finnish environment. Even though most claimed it “should” and “probably will” have an effect, it was clear that the implied problems were more prevalent in other countries, e.g. “Spain, Portugal, Italy, and Greece” (Int 3). One claimed that “a more stable reliable market would have a positive effect on everything” (Int 3), which also is in line with Int 1’s claim that “the audit profession as a whole is generally in favour of increasing the reliability, and that “MAFR should have an effect on the credibility of the European capital markets.”

One interviewee also speculated that the credibility and reliability in Finland will not change, as it already is regarded as trustworthy because of powerful supervisory bodies, large Big Four presence, and a lack of scandals (Int 2).

## **5 DISCUSSION**

In this chapter, the presented results are discussed and analysed in comparison to previous research, as well as evaluated against the various EU objectives and thus tries to answer the research questions of this thesis.

### **5.1 The EAR and Mandatory Audit Firm Rotation**

Interestingly enough, among the interviewees the opinion that MAFR was unnecessary was only shared by the non-APA, while the APAs were mostly content with the incoming forced rotations. Understandingly, the interviewee from the Big Four which has had the largest presence and market share was the most sceptical towards giving up long-term clients without factual reasons, and for unproven potential benefits in independence. Since two out of three interviewees indicated that engagement leader rotations have been and still will be in effect, and that it generally has worked without issues, one might question the effectiveness and cause for even more rotations.

The interview data suggests an overall positive inclination towards the EAR and MAFR, not least through the addition of the retender option which was pointed out repeatedly by the interviewees, which is a notable change in attitude since 2011 when the Green Paper responses were published. Although this thesis was explicitly asking for the auditing professionals' own opinions and not their respective Big Four's official stance, one could still view this as progress considering that MAFR was largely rejected, with only a few exceptions, by both the Big Fours and the audit profession in general.

However, the problem of different interpretations of the EAR still remains. Would the countries adopt different interpretations as the interviews indicated, it could impair the EC's attempts to harmonize the legislation across Europe which would go against the objectives of the EAR. As the overall impacts of the EAR, especially on a European level,

falls beyond the scope of this thesis it would be interesting to see as a research topic on its own, but will not be speculated on further in this thesis.

### **5.1.1 Audit market**

Based on the results of the interviews, the dynamics among the Big Fours has already shifted, but it does not seem likely that mid-sized audit firms would threaten their position at the top, and the EC would thus fail to achieve the objective of diluting the concentration of the Big Fours. As for the Finnish business environment, at least one interviewee thought MAFR could potentially create an opportunity for smaller audit firms to grab market share, since the size of Finnish PIEs are sufficiently small for them to manage.

The Big Four firm with the largest clients and thus the largest market share has and will continually need to rotate off their clients and will therefore lose market share as a result of MAFR. This makes it even more important for audit firms to evaluate which companies they audit and which companies they provide NAS for, as one company cannot provide both which ultimately narrows the choice of audit firms further. It was therefore one of the EC's main objectives to increase this competition at the top with the help of MAFR, something that at least based on the results of this thesis they have unsuccessfully achieved. (European Commission, 2016)

However, since most of the forced rotations are yet to come, it could potentially increase the competition in the audit market since, as one interviewee put it; "we still need to see if the non-Big Fours can take advantage of the situation". It is therefore quite difficult to evaluate whether the objectives posed by the EC still will be achieved, and thusly insufficient evidence for one to draw any definite conclusions on the matter.

### **5.1.2 Reliability and credibility**

The interviews indicated that there was no reliability or credibility issues in the Finnish auditing environment, and it was rather understood by the interviewees that the implied issues the EC is attempting to resolve are more eminent in e.g. southern Europe.

Interestingly, there seemed to be a positive attitude towards increasing the Finnish auditors' already high level of trustworthiness, despite there being any complications. The

general impression of the interviewees was that ‘what is good for the whole market is good for us’, and therefore the EAR would probably have a positive effect on the overall confidence in the audit profession. The objectives regarding investor confidence, to the degree that this thesis can draw such a conclusion, could therefore be seen as reached per definition since the EAR would have sufficiently addressed the doubts in the reports issued by statutory auditors in Finland.

### **5.1.3 Audit costs**

Supported by the largely unanimous opinion that audit costs will increase as a result of MAFR because of hours spent, tender processes, and fee pressures, one can almost certainly claim that the US GAO’s (2003) “fairly certain” approximation of a 17% increase is a reasonable statement. Based on the results of this thesis, the costs accrued by the audit firms would likely be even higher, reaching above 20% and would therefore significantly impact the audit firms’ profitability long term. As the interviews indicated audit fees are constantly being pushed downwards with audit firms having to bear the additional costs for the first years, one might speculate whether it is actually sustainable in the long run.

## **5.2 Augmentation of auditor independence and PS**

The interviews indicated that, even though Finland could theoretically have a large problem with e.g. excessive familiarity because of geographical and demographical reasons, there seem to be no apparent independence issues. Strong ethical principles and a confidence in both the regulation and the company’s own internal controls were noticeable in all interview subjects, which could suggest that the measures imposed by the EU to increase auditor independence is in fact ‘a solution without a problem’, and therefore unnecessary.

However, the auditing professionals themselves seemed relatively positive to MAFR affecting the auditor independence, especially when taking the rest of Europe into consideration. Based on the fact that when explicitly asked whether MAFR will increase auditor independence, all auditing professionals were on the positive side of the spectrum, one might conclude that MAFR could be a suitable measure to increase auditor independence and that the EC successfully reached one of their most desired objectives.



Examining these results, one may argue that the findings are most in line with Nelson (2006), who asserts that independence issues are counteracted by different incentives to act ethically and objectively and is therefore not an evident issue.

However, given the fact that most auditing professionals were positively inclined towards MAFR, one could draw the conclusion that audit tenure does in fact increase independence risk, at least in appearance, and therefore be in line with e.g. Gates et al. (2007); Daniels and Booker (2011); Knechel et al. (2013).

Nevertheless, when considering the fact that none of the interviewees actually thought there were any independence issues in Finland, it could complicate the conclusion that audit tenure is inherently independence impairing. When taking into consideration that none of the interviewees gave a definite answer whether it would improve auditor independence noticeably, it makes the conclusion that auditor independence is negatively affected by audit tenure seem relatively forced. This interpretation is also supported by the results from Eriksson and Erland (2016), where they found that the interviewed auditors agreed excessive audit tenure may not be in anyone's best interest and the familiarity threat could be potentially compromising, but largely denying it being a problem in Sweden.

As PS generally is dependent on auditor independence and there were no discernible differences of opinion among the interviewees, one could draw the conclusion that it remains unaffected at least, with some improvements at best. Interestingly enough, all interviewees agreed an objective view is desirable and that PS is crucial to performing an audit properly, which one could argue fits the framework of the EU's objectives for increasing PS.

### **5.3 Audit quality**

As the interviews were largely inconclusive on whether the audit quality would increase or decrease following a rotation, and there was little harmony in the responses, it complicates the evaluation whether the EC has reached its objectives.

However, there was no doubt amongst the interview subjects whether it would have an effect or not. Since all interviewees expressed and understood the positive effects on quality of rotating audit firms, while only one expressed truly negative consequences, it could potentially suggest that the likelihood of MAFR having more positive than negative effects is probable.

On the other hand, given that the audit fees are being pressured downwards in unison with an increase in audit costs, taking one of the interviewees concerns of limited resources and its potentially detrimental effects on audit quality, one could argue that the majority of the interviewees believe the quality would decrease with limited audit tenure. This is also supported by the fact that the auditor learning curve was familiar to all the interviewees, and albeit one saw it as a positive thing, they all acknowledged it exists and that it could therefore potentially cause a downturn in quality immediately following a rotation. Moreover, even though both the sample size and methodology does not allow for generalizations in this thesis, this conclusion would also be supported by the majority of studies conducted on the subject, e.g. Cassell et al. (2017); Geiger and Raghunandan (2002); Jackson et al. (2008) Knapp (1991).

Based on these results, one could claim that the audit quality has or will suffer as a consequence of MAFR, and that the EC would have possibly decreased the overall audit quality for potential positive effects on e.g. auditor independence or credibility.

However, one has to consider the effects of the handover file which has to be presented to the newly appointed auditor, and whether that counteracts the possible negative consequences of MAFR. Since at least one of the interviewed auditing professionals brought up the subject in a highly positive manner, and that it fell outside of this thesis' scope, it is difficult to draw any definite conclusions based on these results.

## **6 CONCLUSION**

With the EC's objectives in mind, the most important question that this thesis has attempted to answer was whether MAFR has increased auditor independence and PS while also maintaining or improving audit quality. As the research has largely been inconclusive

on whether the benefits of MAFR outweighs its costs and drawbacks, one might question the EC's decision of implementation without sufficient evidence of its effectiveness.

Based on the results of this thesis, one can conclude that according to Finnish Big Four auditing professionals, MAFR could potentially enhance auditor independence and PS. On the topic of whether quality is improved or reduced, the results of this thesis is still inconclusive. Considering that the EU does not state improvement of audit quality as an objective for the EAR, it is therefore left unanswered. Supported by the results of this thesis, when referring to the four problem areas related to MAFR by Dattin (2017), i.e. excessive familiarity, financial incentives, long audit tenure, and a concentrated audit market, one could state that these have seen a marginal improvement at best, since according to the interview subjects these were negligible issues to begin with. Even though the effects on the audit market in Finland has seen some changes, the dilution of concentration amongst the top firms has still not happened.

Given these assumptions, the critical question is then whether these benefits outweigh the apparent increase in costs, which according to the educated guesses provided in this thesis would be around 20%. The EU's attempts to manage the lack of credibility and reliability in the European capital markets deriving from the financial crisis could therefore, supported by this thesis, be perceived as somewhat effective depending on whether the questioned individual agrees the price for this restoration is worth it or not.

On the other hand, given the absence of issues in Finland, one could pose the question whether the legislation is actually necessary in countries with such strong legal and ethical environments. As a former French Minister of the Economy Francis Mer stated; "no set of rules can make up for ethical failure", it could suggest that the results of this thesis are merely a testament to the developed morals of the specific interviewed individuals (Dattin, 2017). However, considering the limitations of this thesis and the relatively small sample size, it is difficult to conclude and would therefore best be researched on its own.

## **6.1 Suggestions for future research**

The scope of this thesis was restricted to effects that were directly derivable from MAFR. As the reform also includes other major changes to the auditing profession, e.g. the NAS

blacklist, and the strengthening of the auditing committee, it provides an exceptional opportunity to explore the impacts of other elements in the EAR.

Moreover, an investor's perspective to increased auditor independence with regards to MAFR could also potentially result in conflicting results, as it would most likely put more emphasis on independence and quality in appearance.

Additionally, because of the limitations and time restrictions of this thesis, the exact costs for the rotations are yet to be conclusive. Since the majority of forced rotations will happen in the near future, it poses a great opportunity for future research to see exactly how the audit fees were affected by MAFR and the EAR.

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# APPENDICES

## Appendix 1: Interview invitation letter

### Invitation to participate in research – Mandatory audit firm rotation

Hi,

My name is Jonathan Myntti, and I'm an Arcada University of Applied Sciences Bachelor's student. I'm writing because I'm currently conducting research on the effects of mandatory audit firm rotation from Finnish auditors' perspective and am therefore looking for experts to interview. The interviews would approximately take 20 - 30 minutes and can be done at any time and place best suited to your convenience, although preferably in the Helsinki area. I am aware of your very busy schedules this time of year, and therefore the interviews can be conducted until mid-March.

The research is of qualitative nature and the interviews would be conducted in English. With your consent the interviews would be recorded, but any wishes to remain anonymous will be respected and any recordings of the interviews will be destroyed after the transcriptions have been made.

Would you be interested in participating in this study, or if you know someone who might be, feel free to either forward this message or be in contact with me.

I'm more than happy to provide any additional information that you might need to make a decision.

Thank you for your time!

Best regards,  
Jonathan Myntti  
+358000000000

## **Appendix 2: Interview guide**

### **Interview guide**

#### **Starting questions and background**

- Please state your current role in the company
- How long have you worked for company x?
- How familiar are you with the EAR and MAFR?

#### **Part I - General questions**

1. What does auditor independence mean to you? - What are the most important aspects?
2. Has your opinion on audit independence changed during your career? How and why?
3. Do you think auditors in large listed companies find it easier or harder to be independent (than in SME's)?
4. What are the biggest threats towards auditor independence? - Are these handled correctly?
5. What is your view on professional scepticism? (Neutral vs presumptive doubt)
6. What are the normal reasons for changing audit firms?
7. Shortly explain what your thoughts are on:
  - a. Excessive familiarity (Closeness between management - audit firm)
  - b. Auditor learning curve (New clients)
  - c. Expectation gap (The difference between the actual and expected performance of an auditor)
  - d. Prohibition of the "Big 4 Only" clause

#### **Part II - EAR and Mandatory audit firm rotation**

8. What is your opinion on the European Audit reform - both positive and negative?
9. What is your opinion on MAFR?
  - a. What is positive about the implementation of MAFR?

- b. What is negative about the implementation of MAFR?
- 10. Why do you think audit firms in general are against MAFR?
- 11. Do you think MAFR will affect the audit quality? - If yes, in what way?
- 12. Do you think MAFR will increase audit costs? - If yes, what have brought these costs, and could you provide a rough estimate? (%)
- 13. Do you think MAFR will affect the structure of the audit market? If yes, how?
- 14. Do you think MAFR is an appropriate measure to achieve EU's goal of increased auditor independence and professional scepticism?
- 15. Do you think MAFR will have an effect on the credibility and reliability of the European capital markets?