Research Thesis
Master of Accounting and Auditing

Is the EU “Going Too Far”?  
Examining the divide between the legislator within the EU and members of the financial market

John Gear

Advisors: Margrét Sigrún Sigurðardóttir & Þórdur Reynisson
School of Business
June 2013
Is the EU “Going Too Far”?

Examining the divide between the legislator within the EU and members of the financial market

John Gear

Research Thesis for Master of Accounting and Auditing
Instructors: Margrét Sigrún Sigurðardóttir & Pórður Reynisson

School of Business, University of Iceland
June 2013
Is the EU “Going Too Far”?

This study is a 30 ECTS research thesis for a Master of Accounting and Auditing with the University of Iceland, School of Business.

© 2013 John Gear

All reproduction is prohibited without the prior consent of the author.

Printed by Háskólaprent

Reykjavík, 2013
Preface

Ernest Hemingway said “It is good to have an end to journey toward, but it is the journey that matters in the end”. Indeed, the journey on which I have travelled in the process of writing this thesis has rewarded me with knowledge and understanding of material that I will carry with me throughout my professional career.

That which I have achieved here, was not achieved alone. I wish to begin by expressing my gratitude to my advisors; Margrét Sigrún Sigurðardóttir and Þórdur Reynisson. Their assistance and guidance throughout this project has been constructive, fair and reliable, and has driven me to consider subjects in far greater depth. My thanks also go to the participants of the interviews for generously offering me their time, honesty and openness. Without the help of my friends Roland and Ricky, my errors in grammar and punctuation would have gone to print. I thank them for their attention to detail.

Lastly, I wish to thank my family for their patience and understanding throughout this eventful journey. I look forward to giving them the attention they deserve.

John Gear
Abstract

In 2010 the European Commission released a discussion paper entitled ‘Green Paper: Lessons from the crisis’ in which they expressed the need to reinforce the audit system in order to help prevent future financial failure. Regarding the issue of auditor independence, the European Commission suggested further legislation to reinforce professional scepticism, mandate the rotation of audit firm and prohibit the provision of non-audit services. A high portion of the 700 responses to the Green Paper received opposed these suggestions. The Commission subsequently presented proposals for amendments to the existing audit directive and for a new regulation.

This research set out to investigate the reason for the opposition, to establish whether there is a markedly different opinion between the different players of the financial market, and to prove or disprove the existence of a ‘divide’ between the legislator and the members of the audit profession. The research was performed in two parts, with analysis of the responses to the Green Paper and subsequent interviews with members of the financial market.

Analysis of the responses found an overwhelming degree of opposition from all of the participants, presenting the hypothesis that the European Commission is exceeding its authority with insufficient regard for the principles of subsidiarity and proportionality; “going too far” with legislative action. Analysis of the interviews, however, found the participants representing the audit profession to be more opposed than the other participants. In consolidating the results, the degree of support voiced by the interviewees is outweighed by the extreme opposition in the overall research.

The existence of the ‘divide’ was ultimately disproved by the fact that the overall opposition is not limited to the members of the audit profession, but is demonstrated equally by all of the members of the financial market. These findings suggest the presented hypothesis to be true and present evidence that the European Commission is indeed “going too far”.
Contents

1 Introduction ......................................................................................................................... 9
  1.1 Research Question ........................................................................................................ 13

2 The Environment.................................................................................................................. 15
  2.1 The Auditor .................................................................................................................... 15
    2.1.1 The Nature of the Audit Firm .................................................................................... 15
    2.1.2 Professional Scepticism.......................................................................................... 16
    2.1.3 Mandatory Rotation ............................................................................................. 18
    2.1.4 The Provision of Non-Audit Services .................................................................... 20
    2.1.5 Audit Quality .......................................................................................................... 21
    2.1.6 The Audit Committee ............................................................................................ 22
  2.2 The Legislator ................................................................................................................ 23
    2.2.1 The History of EU Audit Legislation ..................................................................... 24

3 The Green Paper of 2010 .................................................................................................... 33
  3.1 Impact Assessment ........................................................................................................ 34
  3.2 Legislative Proposals ..................................................................................................... 36
  3.3 Regulation ..................................................................................................................... 36
    3.3.1 The Regulation Concerning Professional Scepticism ............................................. 36
    3.3.2 The Regulation Concerning Mandatory Rotation ................................................ 37
    3.3.3 The Regulation Concerning the Provision of Non-Audit Services ....................... 38
  3.4 Appraisal by the European Parliament ........................................................................ 40

4 Methodology ..................................................................................................................... 42
  4.1 The Sample of Responses ............................................................................................. 43
  4.2 Interview Participants .................................................................................................. 45
  4.3 Limitations of the Research ......................................................................................... 46

5 Results .................................................................................................................................. 47
  5.1 Results According to the Responses to the Green Paper ............................................. 47
    5.1.1 Regarding Professional Scepticism ......................................................................... 47
    5.1.2 Regarding Mandatory Rotation ............................................................................ 52
    5.1.3 Regarding the Provision of Non-Audit Services .................................................... 59
    5.1.4 Overall .................................................................................................................... 63
  5.2 Interview Results .......................................................................................................... 64
5.2.1 In Support of EU Proposals................................................................. 64
5.2.2 Against EU Proposals................................................................. 67
5.2.3 Comparison .............................................................................. 71

6 Conclusion.......................................................................................... 73

6.1 Subsequent Legislative Developments ............................................. 74

7 Discussion .......................................................................................... 75

References ............................................................................................ 78

Appendices ........................................................................................... 87

Timeline ................................................................................................. 87
Black Monday......................................................................................... 90
Robert Maxwell.................................................................................... 90
Polly Peck .............................................................................................. 90
Enron..................................................................................................... 91
WorldCom ............................................................................................. 92
Parmalat ................................................................................................. 92
Royal Ahold .......................................................................................... 93
Mani pulite ............................................................................................ 94
Coding ................................................................................................... 95
List of Figures

Figure 1. Diagram of the relationships between the relevant bodies playing a part in the economy. .......................................................... 9

Figure 2. Illustration of the location of the recognised ‘expectation gap’. ................... 11

Figure 3. Illustration of the demands made on the legislator and the location of the suggested ‘divide’ which is the emphasis of this research ...................... 14

Figure 4. Illustration depicting the position of the auditor as a member of the Relevant Bodies ................................................................. 15

Figure 5. Illustration depicting the position of the legislator as a member of the Relevant Bodies ................................................................. 23

List of Tables

Table 1. Total comprehensive income of three of the ‘big four’ accounting firms. ....... 16

Table 2. Scenarios regarding the provision of non-audit Services as presented by the Impact Assessment ......................................................... 35

Table 3. Scenarios regarding the reduction of the ‘familiarity threat’ and the issue of mandatory rotation as presented by the Impact Assessment. ........ 35

Table 4. Engagement durations for statutory auditors and audit firms carrying out the statutory audit of public-interest entities. ........................................... 37

Table 5. Number of responses to the Green Paper from the relevant interest groups, and sample size for analysis ......................................................... 45

Table 6. Interviewees ........................................................................................................ 45
List of Charts

Chart 1. The position of the audit profession regarding the reinforcement of professional scepticism through additional legislation from the EU. ....................... 48

Chart 2. The position of the investor regarding the reinforcement of professional scepticism through additional legislation from the EU. ......................... 49

Chart 3. The position of the corporation regarding the reinforcement of professional scepticism through additional legislation from the EU. .................. 51

Chart 4. The position of the audit profession regarding mandatory rotation. ............... 52

Chart 5. The position of the corporation regarding mandatory rotation. .................... 54

Chart 6. The position of the investor regarding mandatory rotation. .......................... 55

Chart 7. The position of the audit profession regarding the banning of the provision of non-audit services. ................................................................. 60

Chart 8. The position of the corporation regarding the banning of the provision of non-audit services. ................................................................. 60

Chart 9. The position of the investor regarding the banning of the provision of non-audit services. ................................................................. 62
1 Introduction

Financial society is built up of a number of autonomous mechanisms that function as a whole for the sake of a prosperous community. These individual parts rely on and make demands of each other. They trust each other to fulfil their roles with honesty and integrity and they base their actions on the messages conveyed between one another. The economy thrives as the mechanisms live up to their expectations, but as relationships fail, society suffers as a result of financial scandals and economic crisis.

There are countless elements that play a part in the overall functioning of the economy, but it is corporations and their investors that make it possible for business to survive and expand, and to live up to the increasing demands of society. Investors, however, are only prepared to invest in a company that they trust. They need to be sure that the company has the ability to prosper. For this information they look to the company's financial statements. Investors are assured of the reliability of the financial statements by the auditor. These three bodies; the investor, the corporation and the auditor, are the major parts of the whole which enable the economy to grow. In order to ensure the honesty and accuracy of the functioning of these bodies, rules and regulations are implemented. It is the legislator that plays the fourth important role in the system. The bodies and their relationships can be seen in the following diagram.

Figure 1. Diagram of the relationships between the relevant bodies playing a part in the economy.
Throughout this research, the term ‘Investor’ will define any person or group basing decisions on analysis of the financial statements, often referred to as ‘Users of the Financial Statements’. The term ‘Corporation’ will refer to any entity who prepares financial statement for the use of the ‘Investor’. The ‘Auditor’ is the person or institute who is legally recognised as having the right to provide assurance on the accuracy of the financial statements, and the term ‘Legislator’ refers to the law-making body of the European Union. Collectively, these individuals will be referred to as ‘The Relevant Bodies’.

Investors place a great deal of responsibility on the auditor, basing decisions as to whether to invest in a company on the results of its annual audit (Eilifsen, Messier Jr, Glover, & Prawitt, 2010). The auditor must attempt to pinpoint inaccuracies in the accounts, whether they originate through fraud or unintentional misstatement (International Auditing and Assurance Standards Board, 2012b). He is expected to conduct himself with ‘professional scepticism’, searching for details which challenge the financial information rather than finding evidence that corroborates management representations (International Auditing and Assurance Standards Board, 2012a). Standards and legislation set out methods and approaches to guide the auditor to achieve these expectations, but the exact extent to which these misstatements ought to be detectable, especially when due to fraud, is a matter for debate. The option of providing a modified opinion is available, and indeed demanded of the auditor in the case of the financial statements not providing a true and fair representation of the financial position of the company (International Auditing and Assurance Standards Board, 2012c).

The auditor’s responsibility is to provide ‘reasonable assurance’ that the information in the financial statements accurately represents the financial position. However, that which the investor, the public and other users of the financial statements expect of the auditor is not necessarily the same as the law requires of him, or that which is realistically possible. This difference of expectation is known as the ‘expectation gap’. The concept of an expectation gap was first recognised in 1974, but was not thoroughly examined until 1978 when the Cohen Commission investigated its existence (The Commission on Auditors' Responsibilities, 1978). The Cohen Commission concluded that
a gap did indeed exist between the performance of auditors and the expectations of users.

The most prominent aspects of the expectation gap today relate to who is responsible for the preparation of the financial statements and to the auditor’s ability to detect fraud. The public is often unaware that it is the board of directors and management who are responsible for preparing the financial statements. The auditor is required to assess the risk factors that could lead to misstatement and provide ‘reasonable assurance’ that the financial statements are free of material misstatement whether due to fraud or error (Eilifsen et al., 2010).

The existing ‘expectation gap’ can be seen clearly in the illustration below.

Investors also place responsibility on the legislator. Their trust in the auditor, and his opinion, stems from the knowledge that he is operating within a controlled environment and that he can be held accountable. Investors need to be confident that the auditor providing the audit opinion has acted professionally, demonstrating integrity, independence and objectivity, optimising his chances of detecting inaccuracies (International Ethics Standards Board for Accountants, 2010). The reliability of the auditor hinges on his ability to detect and assess the risk that the financial statements are misstated to a degree that would have an effect on the decision made by the
The role of the Legislator is therefore to implement directives and regulations to ensure the appropriate conduct of the auditor and to create consistency of audit practice within the European Union and other states committed to adopting European Law (The Council of the European Communities, 1986).

One of the main focuses of legislation in recent years has been the strengthening of ethical behaviour within the auditing profession, with emphasis placed on the demand for increased independence and objectivity (The European Parliament and the Council of the European Union, 2006). In October 2010 the European Commission released a Green Paper entitled ‘Audit Policy: Lessons from the Crisis’ in which they expressed the need for changes to legislation surrounding the audit system.

The objective of the Green Paper was to put forward ideas, suggestions and specific questions, in order to gain an understanding of the attitudes and expectations of effected individuals and entities, providing them with the opportunity to express their expectations and to play a part in the development of future legislation (European Commission, 2010). The legislator is not, however, bound to the opinions it receives and there is always the risk of conflicting views; the risk that the legislator will be seen as not living up to the expectations made of him, or the risk that he will be seen as “going too far”.

Three of the questions asked in the Green Paper in its quest to increase auditor independence and objectivity were:

- Should ‘professional scepticism’ be reinforced? How could this be achieved?
- Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of time of an audit firm engagement?
- Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients, or should this be the case for certain types of institutions, such as systemic financial institutions?

Responses to these questions are varied. There is a certain amount of support for the idea of reinforcing professional scepticism, but not necessarily through legislation. The International Standards on Auditing are very clear on the demands they make on the auditor and many feel that these standards are sufficient. The idea of introducing a limitation on the continuous engagement, also known as ‘mandatory rotation’, of audit
firm is criticised. Studies have shown that mandatory rotation does not necessarily have a positive effect on the standard of an audit, and in fact can be detrimental (Cameran, Di Vincenzo, & Merlotti, 2005). The question of the prohibition of non-audit services is also highly criticised (European Commission, 2011e).

In spite of much criticism over the suggestions, the legislator has put forward proposals for the amendment of the existing audit Directive (European Commission, 2011c) and for the introduction of a Regulation on specific requirements regarding the audit of public-interest entities (European Commission, 2011d) stating:

There is an ‘expectation gap’ between what stakeholders expect of an audit and what auditors actually do.

Independence is neither assured nor demonstrable in a paradigm where audit has effectively become one of a plethora of commercial services. The lack of regular tendering of audit services and periodic rotation of audit firms has deprived audit of its key ethos: ‘professional scepticism’.

The prohibition of the provision of non-audit services to the audited entities and even the prohibition of the provision of non-audit services in general would effectively address the need to reinforce independence and professional scepticism. Moreover, stricter rules in the procedure for the appointment of auditors and the introduction of mandatory audit firm rotation would contribute to higher quality audits.

1.1 Research Question
Is there a ‘divide’ between the Auditor and the Legislator?

The ‘expectation gap’ between the investor and the auditor has been proven to exist. What is not clear is whether there are other differences in expectations emerging due to developments in the financial market. The European Commission deems further legislation necessary in order to improve audit independence and professional scepticism (European Commission, 2011c, 2011d), but do the proposed actions of the Commission accurately reflect the expectations of the investor, the corporation and the auditor (Ballon & Georgescu, 2012)?

This research intends to investigate the relationships between these Relevant Bodies¹, focusing on the possible existence of a difference of expectation between the

¹ The Investor, the Corporation, the Auditor and the Legislator. See also pg. 10.
auditor and the legislator within the EU. For the purposes of this research, this expectation difference will be referred to as a ‘divide’. The location of the ‘divide’ can be seen in this illustration.

![Diagram showing the relationship between auditor, legislator, investor, and corporate business]

**Figure 3. Illustration of the demands made on the legislator and the location of the suggested ‘divide’ which is the emphasis of this research.**

In order to prove the existence of the ‘divide’, it will be important to assess whether the view of the legislator in the eyes of the auditor is substantially different to the view of the legislator in the eyes of the other bodies, or whether it is simply that the legislator is exceeding his authority and “going too far” with the proposals.
2 The Environment

2.1 The Auditor

![Diagram showing the position of the auditor as a member of the Relevant Bodies.]

2.1.1 The Nature of the Audit Firm

Auditors are public servants, required by law to have a high level of professional competence and independence in order that they can offer reasonable assurance that the financial statements of a company truly and fairly represent the company’s financial position. The capital market relies on this assurance in making decisions (Eilifsen et al., 2010). The auditor, therefore, has a responsibility to society. An inaccurate audit or an audit failure\(^2\) can contribute to, or cause, the collapse of large corporations, corporations which are running on capital supplied by banks and investors, representing the general public. These financial crises can have catastrophic effects on the lives of the members of society. This can be seen clearly in the cases of Enron and WorldCom,

\(^2\) See Section 2.1.5 Audit Quality
and other well documented financial scandals. It is therefore vital that the auditors respect their duty toward the state and value the powers awarded to them.

At the same time, however, audit firms are private firms aiming to prosper and to achieve a return on invested capital. The majority of the voting shares are required to be held by qualified auditors or audit firms (The European Parliament and the Council of the European Union, 2006). The very nature of this leads inevitably to the majority of the dividends being paid to working partners of the audit firm, giving the staff of the audit firm considerable incentive to drive the firm to prosperity.

These two contrasting roles of the audit firm could be seen to present a conflict of interest. The annual reports of three of the ‘big four’ audit firms show that their profits for the years 2010 and 2011 are considerable (Deloitte, 2012; KPMG Europe LLP, 2012; PricewaterhouseCooper, 2012). Unfortunately, the financial statements for Ernst & Young, also a member of the ‘big four’, were not available.

Table 1. Total comprehensive income of three of the ‘big four’ accounting firms.

<table>
<thead>
<tr>
<th>Total Comprehensive Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
</tr>
<tr>
<td>Deloitte</td>
</tr>
<tr>
<td>KPMG</td>
</tr>
<tr>
<td>PwC</td>
</tr>
</tbody>
</table>

The proposed new audit legislation is criticised for, amongst other things, the fact that it could increase the cost of audit. Given the fact that auditors have a duty towards general society, the question arises, could audit firms provide a higher quality audit by investing more resources and accepting a reduction in these considerable profits?

2.1.2 Professional Scepticism

The International Standards on Auditing describe professional scepticism as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence” (International Auditing and Assurance Standards Board, 2012a).

---

3 See Appendices
The Merriam-Webster online dictionary defines scepticism as “an attitude of doubt or a disposition to incredulity either in general or towards a particular object” (Merriam-Webster, 2012).

Professional scepticism is extremely important when carrying out an audit of the financial statements. The role of the Auditor is to provide reasonable assurance that the financial statements are free of material misstatement. It is, however, the corporation’s management that are responsible for preparing the financial statements. Misstatement can be due to fraud or error, and by approaching the audit with scepticism, an auditor is critical of the assertions made by management and more able to assess the reliability of the information presented. It is particularly important that auditors are sceptical when it comes to assessing management’s fair value assessments (e.g. impairment of goodwill, the recognition of deferred taxes and future cash flows) when considering the entities ability to continue as a going concern (Niven, 2010). These aspects of the financial reporting are subject to a large degree of judgement and can easily offer management the opportunity to improve the appearance of the company on paper and influence the decisions of the user.

The concern is that auditors are not sceptical enough due to the fact that they view the companies they audit as their clients (Whitehouse, 2011) and are too reliant on management’s explanations and representations. The European Commission believes that auditor objectivity is threatened, and feels that professional scepticism needs reinforcing with the implementation of measures to improve auditor independence (European Commission, 2010). This is backed up by evidence suggesting that the most recent crisis could have been partly due to a lack of scepticism in the audit profession (Chi, 2011).

It is not everyone who believes that auditors were responsible for the crisis, and certainly not that it was a lack of professional scepticism that contributed to it. Kingston Smith (2010a) feels that it is a misperception to say, that because clean audit reports were given to the banks in the run-up to the crisis, there must have been a lack of professional scepticism in auditors. They comment on the fact that professional scepticism comes down to a degree of judgement and is therefore open to interpretation.
2.1.3 Mandatory Rotation

An issue concerning the independence, objectivity and scepticism of an auditor, is the potential conflict of interest due to the ‘threat of familiarity’, described as “the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work” (International Ethics Standards Board for Accountants, 2010). In order to reduce this threat, legislation currently requires the rotation of audit partners on a 7 year basis. There is, however, concern that simply rotating the audit partner is not sufficient to reduce this threat to an acceptable level, as it is felt that a new audit partner of the same firm may feel obliged to accept decisions and agreements made by the former partner (European Commission, 2011a). The alternative is to require companies to appoint a new audit firm on a periodic basis. It is important to note that the term ‘Mandatory Rotation’ throughout this research refers to a rotation of audit firm and not purely the audit partner as required by the current legislation.

Mandatory rotation has been debated for decades, first by academics considering the possible advantages and disadvantages and then increasingly, in the wake of financial crisis, governments and institutions (Cameran et al., 2005). There are many theoretical arguments for and against the concept.

Supporters of such a system are convinced that rotating the audit firm results in increased auditor independence and scepticism, leading to a higher quality audit. The following points outline the arguments in favour:

- The long-term relationships developed over years of continuous tenure lead to the auditor treating the audit as a routine procedure (European Commission, 2011a), paying less attention to changes in circumstances (Arel, Brody, & Pany, 2005) and possible audit risks.

- Materiality is a tool used by the auditor to assess whether an inaccuracy in the financial report constitutes a misstatement that could have an effect on the decision made by the investor. Research has shown that in long-term engagements, auditors tend to set the materiality threshold higher than in shorter tenures. A study performed in 1982 showed the average materiality threshold of short-term engagement to be $201,000, whilst the average for long-term was $365,000 (Bates, Ingram, & Reckers, 1982).

- Familiarity can also lead to a self-review threat, described by the Code of Ethics as “the threat that a professional accountant will not appropriately

---

4 Directive 2006/43/EC is currently in force and requires 7 year partner rotation for the audit of PIEs.
evaluate the results of a previous judgement made or service performed by the professional accountant, or by another individual within the professional accountant’s firm or employing organisation, on which the accountant will rely when forming a judgement as part of providing a current service” (International Ethics Standards Board for Accountants, 2010).

➢ Research has shown that a great number of high profile financial reporting failures have occurred in circumstances where the audit firm has been engaged for many years (Arel et al., 2005; Nagy, 2005), and that the highest number of favourable auditors’ reports occurred in circumstances of long-term tenures (Nicholas, Ronald, & Rachel, 2003).

➢ Failures by auditors are often made public, having a great effect on their reputation. Auditors are therefore encouraged to provide a higher audit quality if they are aware that, with the change of audit firm, another auditor will be reviewing their work (Hoyle, 1978).

➢ Mandatory Rotation is believed to be a way to stimulate competition, giving new players access to the market, and potentially reducing the cost of an audit (European Commission, 2011a).

There are four main issues addressed by those who oppose the concept of mandatory rotation; increased cost of audit, the loss of knowledge leading to a lower quality audit, the difficulty of maintaining specialised knowledge in specific industry and the fear that it would lead to a lack of choice when appointing a new auditor (European Commission, 2011a). The following list summarises these issues:

➢ Increased cost – an auditor is required to obtain an understanding of the audited entity in order to recognise factors that constitute a risk that the financial statements contain material misstatement (International Auditing and Assurance Standards Board, 2012b). The process of gaining this understanding takes more time during the first years of an audit engagement, suggesting that an audit becomes less costly after the initial familiarisation period. Mandatory Rotation would therefore lead to these higher initial cost being incurred more often.

➢ Lower audit quality – audit quality is directly affected by the auditor’s knowledge of the entity. The more knowledge the auditor has of the entity the more likely that risks to audit quality will be located.

➢ Specialised knowledge – having industry specific knowledge of an entity increases the auditor’s ability to provide a higher quality audit at a reasonable cost (Cowperthwaite, 2011) and the auditor is required by the International Standards on Auditing to “obtain an understanding of the relevant industry” (International Auditing and Assurance Standards Board, 2012b) whilst become familiar with the audited entity.

➢ Lack of choice – there is the fear that, as all client companies would initially be changing auditor at the same time, some companies would be forced to choose the audit firm that has not already become engaged with another client.
Research carried out concerning mandatory rotation has shown both support and opposition; the overall results are inconclusive (Arel et al., 2005; Hoyle, 1978; Nagy, 2005). There is, however, more documentation opposing the system (Cameran et al., 2005). Italy is the only EU member state with a Mandatory Rotation system. Research carried out has therefore often examined situations where ‘voluntary rotation’ has occurred, and attempted to use these results in assessing the effects that ‘mandatory rotation’ would have. This has been recognised as a weakness in much of the research (Cameran, Prencipe, & Trombetta, 2009; Nagy, 2005). Research carried out in Italy is included in the studies opposing mandatory rotation, finding that a voluntary change of auditor tended to improve audit quality while a mandatory change did not (Cameran et al., 2009).

2.1.4 The Provision of Non-Audit Services

Non-audit services (NAS) are services, carried out by audit firms, that are not directly related to an audit of the financial statements. These services include bookkeeping, valuations, taxation services, internal audits, IT services, legal services and advice, and other advisory services. The provision of these services to the audit client has long been considered a source of conflict of interest, potentially having a damaging effect on the independence and professional scepticism of the auditor (European Commission, 2011a). NAS typically account for the main part of an audit firm’s revenues (The Professional Oversight Board, 2012) and the concern is that auditors are encouraged to give favourable opinions in order to retain non-audit assignments. This is highlighted by a report ordered by the House of Commons in the UK in 2009 which concludes in paragraph 237:

...we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised (Commons Select Committees: Treasury, 2009).

---

5 The system in Italy has been in place for 20 years.
This poses the question, as asked in the Green Paper of 2010\(^6\), of whether auditors and audit firms should be banned from providing these services to their audit clients, or even all-together.

At present the provision of NAS is not prohibited. Instead, Article 22 of the current Statutory Audit Directive (2006/43/EC) states that an audit should not be provided in cases where “an objective, reasonable and informed third party would conclude that the statutory auditor’s or audit firm’s independence is compromised” (The European Parliament and the Council of the European Union, 2006). This is not very specific and allows Member States a lot of freedom in their interpretation. In France, there is a complete ban on the provision of NAS from any member of the auditor’s network to any other member of the audited company’s group, whilst in other Member States, revenues from NAS constitute a large part of the firm’s total earnings. In the UK, the provision of NAS amounted to 34% of the combined audit and NAS fees of 8 important banks (European Commission, 2011a).

Over the past few years, the total revenues received for NAS services have been steadily increasing (The Professional Oversight Board, 2012), although there is a decrease in revenues from the provision of NAS to audit clients. This decrease is almost certainly in response to the changing regulatory environment, with governments increasing restrictions.

### 2.1.5 Audit Quality

The most simple definition of audit quality declares that an audit is of quality if the auditor detects misstatements in the financial statement and successfully reports them (Le Vourc'h & Dean, 2011). This is consistent with the idea that an audit failure occurs when the auditor fails to detect or report the existence of misstatements. Audit quality and audit failure are therefore negatively correlated (Quick, Turley, & Willekens, 2008).

Quick et al. (2008) explains:

Audit failures are associated with two conditions: first, when the auditor does not deliver the implicit audit quality set by the regulations, and second when audit quality achieved from following regulation fails to reveal all material misstatements in the financial statements.

\(^{6}\) See Section 3 of this report.
Audit quality may also be perceived in different ways according to the way it is assessed. The investor would be likely to see audit quality as relating to the method of reporting, the reputation of the auditor and how well the report lives up to expectations. The corporation may place emphasis on the quality of communication and interaction of the auditor (International Auditing and Assurance Standards Board, 2011).

Audit quality is influenced by a number of factors; inputs, outputs and context factors. The inputs are the things that the auditor relies on in order to perform the audit. This could be e.g. auditing standards, the auditors competence and expertise, his ethical values, and the way the audit is planned. Outputs are the issues considered by those for whom the audit is performed. Stakeholders and management are typically interested in the audit report accurately conveying the outcome of the audit and the ability of the auditor to communicate. Context factors are the inherent conditions that can have an effect on audit quality such as control environment which exists within the audited entity (International Auditing and Assurance Standards Board, 2011).

It is the fact that audit quality means different things to different people that make it difficult to define precisely, but to summarise the main issues; if an audit manages to identify and report on issues involving misstatement whether due to fraud or error, and effectively and comprehensively communicates the relevant information to each of the Relevant Bodies, it can be considered a quality audit.

2.1.6 The Audit Committee

Although the concept of an Audit Committee existed in many long-established corporate governance codes (Working Group of the European Confederation of Directors' Associations, 2011), it was Directive 2006/43/EC that took the step of legislating its existence and role. According to the directive:

Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing (The European Parliament and the Council of the European Union, 2006).
The role of the Audit Committee is to:

- monitor the financial reporting process;
- monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- monitor the statutory audit of the annual and consolidated accounts;
- review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity;
- to make a recommendation on the choice of statutory auditor.

With the introduction of the new Regulation on the statutory audit of PIEs, the demand concerning the composition of the audit committee has been changed. Whereas the existing Directive requires the audit committee to have at least one member who is competent in accounting and/or auditing, the new Regulation will require that at least one member has experience and knowledge in auditing and another in accounting and/or auditing.

2.2 The Legislator

![Diagram](image)

**Figure 5. Illustration depicting the position of the legislator as a member of the Relevant Bodies.**

---

7 See Section 3.3 Regulation
The formation of the European Union in 1952 was driven by a specific need, the need to preserve the peace. Actions subsequently taken by the EU are based on newly arising needs due to societal development. When the legislator makes the move towards further legislation, it is in response to specific events. Legislative developments, in this context, owe their roots to the treaties and the objective of the modernisation of company law and the enhancement of corporate government (Gornik-Tomaszewski & McCarthy, 2005). “Rationale for the expansion of auditing regulations” lies in the goal of “restoring public trust in audited financial information such that trust in the capital markets can be regained” (Quick et al., 2008).

When considering actions, the EU must abide by the principles of subsidiarity and proportionality, as established by the Treaty on European Union which came into effect in 1993. According to the Treaty:

Under the principle of subsidiarity, in areas which do not fall within its exclusive competence, the Union shall act only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States (European Union, 1993).

Under the principle of proportionality, the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties (European Union, 1993).

These principles are in place to ensure that the legislator does not “go too far”. They influence the type and extent of legislative action taken by the EU.

### 2.2.1 The History of EU Audit Legislation

Legislation specific to the audit was not seen until the implementation of the Eighth Council Directive in 1984. Until then, legislation was directed at financial reporting. This legislation, which had its roots firstly in the Treaty Establishing the European Economic Community (The Council of the European Communities, 1957) and subsequently in the General Programme for the abolition of restrictions existing within the Community on Freedom of Establishment as laid down in 1961 (Council of the

---

8 The Maastricht Treaty
9 A detailed timeline for the developments concerning audit legislation can be seen in the Appendices.
10 Directive 84/253/EEC
11 The Treaty of Rome
European Economic Community, 1961), was in the form of the First Council Directive\textsuperscript{12}. This Directive made the demand that companies prepare a yearly financial report in order to provide investors with the necessary information on which to base their decisions (The Council of the European Communities, 1968).

The first reference specific to audit was in the ‘Fourth Council Directive’\textsuperscript{13} of 1978. In addition to describing in detail the required methods of accounting, the Directive made the demand for an audit of the financial statements. Article 51 stated:

1. (a) Companies must have their annual accounts audited by one or more persons authorized by national law to audit accounts.
   
   (b) The person or persons responsible for auditing the accounts must also verify that the annual report is consistent with the annual accounts for the same financial year.

The demands made by this directive concerning the audit were not very specific and made no reference to specific standards on auditing or methods that the auditor should follow (The Council of the European Communities, 1978).

2.2.1.1 The Eighth Council Directive

The Eighth Council Directive (84/253/EEC) of 1984 was the first legislation dealing specifically with the person responsible for carrying out the statutory audits\textsuperscript{14} of accounting documents – the auditor. The directive did not present methods to be used in carrying out an audit, but focused on the issue of who should be allowed to perform the audit (The Council of the European Communities, 1984). In order to be approved for an audit engagement, a person should be independent and of good repute, with a high level of theoretical knowledge and professional competence. The high level of theoretical knowledge and professional competence was ensured as stated in Article 4:

\begin{quote}
A natural person may be approved to carry out statutory audits of the documents referred to in Article 1 (1)\textsuperscript{15} only after having attained university
\end{quote}

\textsuperscript{12} Directive 68/151/EEC  
\textsuperscript{13} Directive 78/660/EEC  
\textsuperscript{14} The term ‘statutory audit’ refers to an audit that is required by an article of legislation or other rule. In 2011, the European Commission proposed to change the definition of the ‘statutory audit’ to include an audit voluntarily conducted by small undertakings (European Commission, 2011c). The motivation behind this was the need to be able to apply the proposed Directive to any audit and not only the audit of large institutions and PIEs.  
\textsuperscript{15} Annual accounts of companies and firms, and consolidated accounts in accordance with the Seventh Council Directive (83/349/EEC).
entrance level, then completed a course of theoretical instruction, undergone practical training and passed an examination of professional competence of university, final examination level organized or recognized by the state (The Council of the European Communities, 1984).

The directive required that the “examination of professional competence guarantee the necessary level of theoretical knowledge of subjects relevant to the statutory auditing of the documents and the ability to apply such knowledge in practice”. It listed the subject areas that should be included in the examination. In the case of the approval of an audit firm, as opposed to the individual auditor, the majority of the members of the administrative or management body would be required to satisfy the same conditions.

Section III covered Professional Integrity and Independence, but while defining the minimum requirements, did not contain any specific guidance. Article 23 stated simply that the auditor should carry out an audit with professional integrity and Article 24 stated that Member States not allow an auditor to carry out an audit if he was not independent in accordance with national law.

In Section IV, the directive required “Member States to ensure that the names and addresses of all natural persons and firms of auditors approved by them to carry out statutory audits be made available to the public” (The Council of the European Communities, 1984).

**2.2.1.2 Justification for EU Interest**

The justification for legislative actions up to this point had been the on-going objective of the Freedom of Establishment as set out in the General Programme, and the provision provided in the Treaty Establishing the EEC.

In 1985, the European Commission, under its then president, Jacques Delors, published a White Paper\textsuperscript{16} which presented the objective of the “abolishment of all physical, technical and tax-related barriers to free movement within the Community” (European Union, 2012). This Paper took the existing Freedom of Establishment objective further stating:

\textsuperscript{16} A White Paper details decisions or conclusions made regarding a specific subject area or debate, and presents subsequent actions and their objectives.
Unifying this market presupposes that Member States will agree on the abolition of barriers of all kinds, harmonisation of rules, approximation of legislation and tax structures, strengthening of monetary cooperation and the necessary flanking measures to encourage European firms to work together (Commission of the European Communities, 1985).

A timetable included in the White Paper allowed for the completion of the described Internal Market by 1992, or within 7 years. The paper was influential in the objective presented by the Single European Act of 1986, a revision of the existing Treaty. In order to achieve the objectives of the White Paper, the Act aimed at extending the powers of the community and, by means of a comprehensive legislative programme, increasing the freedoms between nations in order to create a Single Market (The Council of the European Communities, 1986). The Act contributed to the justification for further audit legislation but was not the only enabling instrument; the need for further legislation was also in response to the emerging financial failures (Commission of the European Communities, 1996).

2.2.1.3 Response to Financial Failures

The late 1980s and the 1990s saw a drastic increase in the number of banking crises. In America between 1980 and 1994 “more than 1,600 banks insured by the Federal Deposit Insurance Corporation were closed or received financial assistance” (Federal Deposit Insurance Corporation's Division of Research and Statistics, 1997). 1987 saw the start of difficulties for Danish banks (Østrup, 2010) and from 1988 to 1993, banks accounting for 60% of bank lending to the non-financial domestic sector in Norway were in trouble (Vale, 2005). Banks in Sweden, Japan, the United Kingdom and other countries were also experiencing difficulties (Hoggarth, Milne, & Wood, 1998). Most of the crises in the banking world were caused by external economic influences, but the shutting down of the Bank of Credit and Commerce International (BCCI) in 1991 (Engdahl & Steinberg, 1995) and the collapse of Barings Brothers in 1995 (“A fallen star,” 1995) drew far more attention, as these failures were due to fraud.

The need for a response to the financial failures was demonstrated further by the stock exchange crash of 198717, the scandals of Robert Maxwell18 and Polly Peck19, and by the instigation of the “Mani pulite” investigation20 in Italy.

17 See Appendices
The Single European Act, these financial failures, and the scandals, offered the necessary justification for the development of more complete audit legislation.

2.2.1.4 The 1996 Green Paper

The next step in the development of audit legislation was the presentation by the Commission of a Green Paper in 1996. The Paper was entitled ‘The Role, the Position and the Liability of the Statutory Auditor within the European Union’ and was the most comprehensive document to have been released by the Commission in relation to audit legislation. The document presented suggestions for future actions in response to the recent events and in order to achieve the objectives set out in the Single European Act. It covered more areas than previous documents, addressing issues such as the need for definitions, auditor independence, fraud, professional competence, quality control and the relationship between the auditor and company management.

The introductory paragraph of the Green Paper acknowledged that the requirement to have the annual and consolidated accounts of certain companies audited by a qualified professional, as introduced by the Directives, was designed to enhance the confidence of all parties concerned with the affairs of companies (Commission of the European Communities, 1996) and continued stating:

The increased transparency resulting from the harmonisation of the financial information published by companies together with the increased reliability of that information were regarded as an important contribution to the completion of the Single Market.

The Paper made reference to the recent financial failures and questioned the function of the statutory audit and the independence of the auditor. It was also concerned that the absence of a common EU view of the auditor was having a negative impact on audit quality and on one of the founding objectives, the Freedom of Establishment. The reasons for the need for further audit legislation were clearly explained in this introduction.

The first issue discussed in the Paper was concerning a common definition of the statutory auditor. Although the directives made the demand for the accounts to be

---

18 See Appendices
19 See Appendices
20 The Clean Hands Investigation. See Appendices
audited by a qualified professional, they did not include a definition of the statutory audit\textsuperscript{21}. The definition adopted by the International Federation of Accountants (IFAC) stated “the objective of an audit is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework” (Commission of the European Communities, 1996). This definition was not, however, recognised by the European Union and the lack of a common definition was seen as contributing to the ‘expectation gap’.

The need for a common definition was also recognised in concern with the auditor’s role in detecting fraud, an important issue following the recent scandals. Regulatory bodies in a number of Member States had issued auditing guidelines which stated that the auditor should plan the audit so as to have a reasonable expectation of detecting fraud, but the EU had not addressed this issue specifically. A priority of the Green Paper was therefore to define the statutory audit. This would then provide a more reliable basis for the development of further legislation and help to more clearly define the role and the expectation of the auditor.

Regulation of auditor independence was addressed, recognising that independence was the main means by which the statutory auditor could demonstrate that he could perform his task in an objective manner, increasing his ability to detect fraud and other misstatements. The Eighth Council Directive had stated that the auditor should be independent but provided no specific guidance. The Green Paper suggested, for the first time in connection with EU legislation, the need for a comprehensive definition of independence and for the development of a common core of essential principles which could be developed by the profession at EU level.

Further on the subject of independence, the Paper dealt with the question of whether the statutory audit should be made subject to a system of mandatory rotation\textsuperscript{22}. However, it was acknowledged that arguments in favour of such a system were inconclusive. Mandatory rotation had been in place in two Member States, only to be abolished (in at least one). An alternative suggestion was the rotation of audit partners within the same firm.

\textsuperscript{21} See Footnote 14 on pg. 25.
\textsuperscript{22} See Section 2.1.3 Mandatory Rotation
The Paper also questioned to what extent the EU could refer to the International Standards on Auditing.

In suggesting possible priorities for future action, the Paper paid particular attention to the principles of subsidiarity and proportionality. The Commission would not create unnecessary legislation, but confirmed that it “would not hesitate to propose new legislation where it believed necessary” (European Commission, 1998).

2.2.1.5 The Way Forward
The responses to the Green Paper showed general agreement that the EU needed “a framework of reference in the auditing field, and that such a framework should be based as far as possible on existing international standards” (European Commission, 1998). As a result, the Commission, with the support of the European Parliament, decided to set up a Committee on Auditing, composed of government experts nominated by Member States, that would have special responsibilities for auditing matters (European Commission, 1998).

The principle tasks of the Committee were to:

- review the existing International Standards on Auditing (ISAs) and determine whether their application met the full need for auditing standards in the EU;
- examine the audit quality monitoring systems in the Member States;
- examine a set of core principles on independence developed by the European accounting profession.

2.2.1.6 On Quality Assurance
As a result of the work of the Committee on Auditing, the European Commission issued a Recommendation, in 2001, on quality assurance for the statutory auditor. Quality assurance was described as being “the profession’s principal means of assuring the public and regulators that auditors and audit firms are performing at a level that meets the established auditing standards and ethical rules” (European Commission, 2000). Quality assurance, however, was a relatively new concept with not all of the Member States having implemented it, as of 1999. The Commission recognised the lack of an internationally accepted standard defining minimum requirements, and felt the need for a benchmark for Member State quality assurance systems. As a first step, the
Commission made recommendations concerning the structure of the quality control system and the system of review and public oversight.

**2.2.1.7 Statutory Auditors’ Independence**

The Committee on Auditing agreed that each Member State should apply a set of principles in order to provide auditors, regulators and the public with a common understanding of the independence requirements. In 2002 the Commission presented a Recommendation on “Statutory Auditors’ Independence in the EU: A Set of Fundamental Principles”. These Principles were extremely comprehensive and were intended to provide a level playing field for the provision of audit services. The intention was that they would be further built upon in order to develop common independence standards (Commission of the European Communities, 2002).

**2.2.1.8 Further Justification**

In 1999, still striving to reach the goal of a Single Market, the EU introduced a Financial Services Action Plan (FSAP). This plan set out a list of actions to be completed by the year 2005 (Commission of the European Communities, 1999). Motivation was further provided by the collapse of Enron23 in 2001, which became the focus of a meeting with the ECOFIN24 council in Oviedo, Spain in April 2002.

The actions of Enron’s auditor in the US had a major effect on the public trust of the audit function, highlighting weaknesses of the audit system, not only in the US but in also in the EU. The ECOFIN Council, recognising the work of the Committee on Auditing and the aims of the FSAP, agreed that the recommendations concerning quality assurance and auditor independence should be adopted as quickly as possible, but that further regulation was unnecessary. The Council drew particular attention to the issues of the provision of non-audit services and the rotation of key audit partners, as presented in the Fundamental Principles of the Commission’s Recommendation. They also pointed out the importance of the implementation of a set of agreed auditing standards, the role of the Audit Committee and the possible adoption of a Code of Ethics to underpin professional integrity within the Union, along with the need to revise the 8th Council Directive (Commission of the European Communities, 1999).

---

23 See Appendices
24 The Economic and Financial Affairs Council
The faith of the public was further weakened in 2003 by the European financial scandals at Parmalat\textsuperscript{25} and Royal Ahold\textsuperscript{26}.

\textbf{2.2.1.9 Directive 2006/43/EC}

These events drove the Commission to release, in 2003, a Communication on Statutory Audit entitled ‘Reinforcing the Statutory Audit in the EU’. This Communication included a 10 point action plan that set out steps to be taken both in the short-term (2003 – 2004) and in the mid-term (2004 – 2006) (Commission of the European Communities, 2003). The result of these steps was a proposal for a revised 8\textsuperscript{th} Council Directive which came into effect in May 2006, and is in effect today.

Directive 2006/43/EC is by far the most comprehensive audit legislation from the EU. Whereas the original 8\textsuperscript{th} Council Directive was mostly concerned with the approval of a person carrying out an audit, the revised Directive defines appropriate auditor conduct and the relevant rules. According to the Directive, Member States are required to ensure that all statutory auditors and audit firms are subject to “principles of professional ethics, covering at least their public-interest function, their integrity and objectivity and their professional competence and due care”. Auditors are required to document all significant threats to their independence, as well as the safeguards applied to mitigate those threats. An auditor may not carry out an audit if there is any “direct or indirect financial, business, employment or other relationship – including the provision of additional non-audit services – between the auditor and the audited entity...” (The European Parliament and the Council of the European Union, 2006).

In the case of public-interest entities (PIEs), Member States are required to implement a 7 year limit to the length of time the key audit partner may audit continuously the same firm. This requirement is also known as ‘Audit Partner Rotation’\textsuperscript{27}.

In addition to these provisions, the Directive makes the requirement for an Audit Committee\textsuperscript{28}, and addresses issues such as Quality Assurance and Public Oversight, reducing the extent to which the audit profession has been primarily a self-regulated profession (The European Parliament and the Council of the European Union, 2006).

\textsuperscript{25} See Appendices
\textsuperscript{26} See Appendices
\textsuperscript{27} This should not be confused with the term ‘Mandatory (Audit Firm) Rotation’ as used in the context of this research. See Section 2.1.3 Mandatory Rotation.
\textsuperscript{28} See section 2.1.6 The Audit Committee
3 The Green Paper of 2010

In 2010 the EU presented a Green Paper entitled ‘Audit Policy: Lessons from the Crisis’. In this paper, the European Commission expressed concern that, whilst the role of various members of the financial market had been scrutinised following the crisis, the role of the auditor had not. They also questioned how it was possible that so many banks had been given a clean bill of health so shortly before they collapsed, and felt that it was therefore necessary to examine the role and the scope of the audit in the general context of financial market regulatory reform (European Commission, 2010).

The EU has a general objective which is consistent with fulfilling the goals set out in the Treaties and subsequent initiatives\(^{29}\). The objective is:

To contribute to the efficient functioning of financial and non-financial markets by strengthening the market role of the audit profession to provide relevant economic agents and the market with more reliable, transparent and meaningful information, at an acceptable cost, about the veracity of financial statements of companies (European Commission, 2011b).

In striving to achieve this goal, the Commission asked questions in order to assess the different policy options and to calibrate any future actions. Three of the questions relevant to this research concern the strengthening of auditor independence. These questions addressed the issues of professional scepticism, mandatory rotation and the provision of non-audit services:

- Should ‘professional scepticism’ be reinforced? How could this be achieved?
- Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of time of an audit firm engagement?
- Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?

\(^{29}\) Explained in Section 2.2.1 The History of EU Audit Legislation
3.1 Impact Assessment

During 2011, an impact assessment was carried out by staff of the Commission, outlining the different scenarios representing different levels of legislative intervention.

Under the general objective (above), the assessment recognised five specific objectives in order to achieve the main goal. Of these five, the second objective is relevant to this study:

Reinforce the independence and professional scepticism of statutory auditors and audit firms in the provision of statutory audit to PIEs (European Commission, 2011a).

The impact assessment presented a summary of the options for consideration. These can be seen in the tables below. (The options highlighted in bold are the options which were preferred by the Impact Assessment (European Commission, 2011b)).
Table 2. Scenarios regarding the provision of non-audit Services as presented by the Impact Assessment.

**Policy options to reduce and mitigate the risk of any conflict of interest due to the provision of non-audit services to PIEs**

0. Baseline scenario. General criteria on independence applicable, but no direct prohibition of additional non-audit services to the audited entity.

1. Prohibition of the provision of certain non-audit services to the audited entity (blacklisting certain services).

2. Prohibition of the provision of any non-audit services to the audited entities. But the provision of non-audit services to entities which are not audited would remain possible.

3. Pure audit firms. Approved audit firms will only be allowed to provide statutory audit services and be unconnected to firms providing certain non-audit services to audited entities.

Table 3. Scenarios regarding the reduction of the ‘familiarity threat’ and the issue of mandatory rotation as presented by the Impact Assessment.

**Policy options to reduce and mitigate the risk of any conflict of interest due to a “familiarity threat”**

0. Baseline scenario. Restrictions on the duration of audit engagements only apply to the key audit partner; no specific requirements at EU level, except regarding ethics and the prohibition of contingent audit fees.

1. Mandatory rotation of an audit firm. Audit firms will step down after a certain number of years of engagement and would only be allowed to take a new engagement with the same audited entity after a cooling-off period.

2. Strengthening the role of the audit committee in overseeing the work of the statutory auditors/audit firm.

3. Establishing additional requirements on the internal organisation and governance of audit firms.

4. Combination of options 1 to 3.

These options were presented in order of intensity, option 0., the baseline scenario, represented the case that no change would be made to the existing legislation and the subsequent options represented scenarios entailing the introduction of more restrictive legislation.
3.2 Legislative Proposals
The Commission has concluded that the objective cannot be sufficiently achieved by Member States and that action at an EU level is therefore necessary (European Commission, 2011c). The action proposed consists of the creation of a Regulation on the Statutory Audit of public-interest entities, and the modification of the existing Directive 2006/43/EC.

3.3 Regulation
The proposal for the Regulation is extremely comprehensive, covering conditions for carrying out statutory audits of public-interest entities (PIEs), the appointment of the auditor or audit firm, issues surrounding quality assurance, the role of the competent authorities and systems of oversight and administrative sanctions and measures.

For the purpose of this research the proposals concerning the provision of non-audit services\(^{30}\) and the mandatory rotation of audit firms\(^{31}\) will be examined in more detail.

3.3.1 The Regulation Concerning Professional Scepticism
According to Article 15 of the Regulation:

When carrying out the statutory audit of a public-interest entity, the statutory auditor or audit firm shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to facts or behaviour indicating irregularities, including fraud or error could exist, notwithstanding the auditor’s or firm’s past experience of the honesty and integrity of the audited entity’s management and of the persons charged with its governance.

The statutory auditor or the audit firm shall maintain professional scepticism in particular when reviewing management estimates relating to fair values and the impairment of goodwill and other intangibles and future cash flow relevant to the consideration of the going concern.

For the purpose of this Article, ‘professional scepticism’ means an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence (European Commission, 2011d).

---

\(^{30}\) See Section 2.1.4 The Provision of Non-Audit Services

\(^{31}\) See Section 2.1.3 Mandatory Rotation
3.3.2 The Regulation Concerning Mandatory Rotation

Article 33 of the Regulation begins by demanding that the initial engagement of a statutory auditor or audit firm be not less than two years. The PIE may renew this engagement only once.

In the case of a PIE being audited by one statutory auditor or audit firm, the total length of the combined engagements may be no more than 6 years. The competent authority\(^{32}\) may, however, grant an extension of two years. If two statutory auditors or audit firms are appointed continuously for a period of 6 years, the maximum length of engagement may not exceed 9 years, although this too may be extended by the competent authority to a period of 12 years. The following table demonstrated this information.

Table 4. Engagement durations for statutory auditors and audit firms carrying out the statutory audit of public-interest entities.

<table>
<thead>
<tr>
<th></th>
<th>PIE audited by one auditor or audit firm</th>
<th>PIE audited by two auditors or audit firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial engagement</td>
<td>2 years</td>
<td>2 years</td>
</tr>
<tr>
<td>Renewal</td>
<td>4 years</td>
<td>7 years</td>
</tr>
<tr>
<td>Extension granted</td>
<td>2 years</td>
<td>3 years</td>
</tr>
<tr>
<td>Total engagement</td>
<td>8 years</td>
<td>12 years</td>
</tr>
</tbody>
</table>

After the expiration of the engagement, the statutory auditor or audit firm may not be reinstated before a period of four years has elapsed.

The key audit partner(s) may only continuously audit an entity for a period of 7 years, after which he, she or they must wait for three years before being reappointed to the audit of the same entity. This is consistent with the demands made by the existing Directive.

In addition to this, the auditor or audit firm must establish “an appropriate gradual rotation mechanism with regard to the most senior personnel involved in the audit”. They must be able to demonstrate to the competent authority that such a system is in place and has been adapted to the size and nature of their activities (European Commission, 2011d).

\(^{32}\) Public oversight organised by the Member State.
3.3.3 The Regulation Concerning the Provision of Non-Audit Services

According to Article 10 (1) of the Regulation proposal:

A statutory auditor or an audit firm carrying out the statutory audit of public-interest entities may provide to the audited entity, to its parent undertaking and to its controlled undertakings, statutory audit services and related financial services (European Commission, 2011d).

The emphasis here is on the fact that the services must be directly related to the audit and be services that are not likely to contribute to a conflict of interest. These permitted services are listed in Article 10 (2) (a – f) and include the provision of various corporate assurance services, certification on compliance matters and other duties related to audit work as legislated by the EU. In the event that the audit firm is providing any of these additional services, according to Article 9 (2), the fees paid for them may not be more than 10% of the fees paid for the audit itself.

The issue of the provision of services that are not related to the audit is dealt with in Article 10 (3):

A statutory auditor or an audit firm carrying out statutory audit of public-interest entities shall not directly or indirectly provide to the audited entity, to its parent undertaking and to its controlled undertakings, non-audit services (European Commission, 2011d).

Here, the Regulation is very specific and continues to set out the services that may not be provided. These services are listed in two categories:

a) services entailing conflict of interest in all cases:
   i) expert services unrelated to the audit, tax consultancy, general management and other advisory services;
   ii) bookkeeping and preparing the accounting records and financial statements;
   iii) designing and implementing internal control or risk management procedure related to the preparation and/or control of financing information included in the financial statements and advice on risk;
   iv) valuation services, providing fairness opinions or contribution-in-kind reports;
   v) actuarial and legal services, including the resolution of litigation;
vi) designing and implementing financial information technology systems for public-interest entities as referred to in Article 2(13)(b) to (j) of Directive 2006/43/EC;

vii) participating in the audit client’s internal audit and the provision of services related to the internal audit function;

viii) broker or dealer, investment adviser, or investment banking services.

b) services which may entail conflict of interest:

i) human resources services, including recruiting senior management;

ii) providing comfort letters for investors in the context of the issuance of an undertaking’s securities;

iii) designing and implementing financial information technology systems for public-interest entities as referred to in Article (2)(13)(a) of Directive 2006/43/EC;

iv) due diligence services to the vendor or the buy side on potential mergers and acquisitions and providing assurance on the audited entity to other parties at a financial or corporate transaction.

The services in category a) are services which can always be considered a source of conflict of interest. Even if the auditor is independent in mind, he cannot be considered to be independent in appearance when performing these services to the audited entity.

The services listed in category b), however, will not always pose a threat to the auditor’s independence and, for this reason, the Regulation provides exceptions. The services mentioned in b)(i) and (ii) may be provided subject to prior approval by the audit committee, and the services mentioned in b)(iii) and (iv) may be provided subject to the prior approval by the competent authority.

Paragraph 5 of Article 10 implements further restrictions on audit firms belonging to a network with combined revenues of more than EUR 1.500 million. Such firms may not provide non-audit services of any kind to any PIE, whether they are auditing the entity or not, if more than one third of its annual revenue is generated from the audit of large PIEs. This article means that many large audit firms will be in the position that they become ‘pure audit firms’, providing only audit services.

33 Entities such as credit institutions, insurance undertakings and investment firms etc.
34 Entities whose transferable securities are admitted to trading on a regulated market.
35 See Section 2.1.6 The Audit Committee
36 Public oversight organised by the Member State.
3.4 Appraisal by the European Parliament

In July 2012 the European Parliament released its ‘Appraisal on the Impact Assessment’ carried out by the Commission Staff regarding the impact of the various legislative scenarios with different intensities. This appraisal was prepared in order to help the Parliament’s Legal Affairs Committee (JURI) in their consideration of the proposed legislation and to assess whether the Impact Assessment was carried out according to the Impact Assessment Guidelines published by the Commission (Ballon & Georgescu, 2012).

In its Resolution of 13th September 2011, the Parliament recognised the importance of auditor independence and the need to strengthen the audit system, and therefore welcomed the Commission’s Green Paper. They stressed, however, the importance of a “wide-ranging and in-depth impact assessment” (European Parliament Committee on Legal Affairs, 2011). Various concerns are identified in the Appraisal.

The first area of concern are the drivers that the Commission believes justify further legislation. The Commission presents two specific drivers; a deficient audit quality that has contributed to the financial crisis and a lack of competition in the audit market due to the prominence of the four largest audit firms. The Appraisal begins by questioning the relationship between audit quality and the financial crisis, claiming that the Commission has not presented enough evidence to support the theory that it was a lack of audit quality that caused the financial crisis. The Parliament also finds that the Commission needs to explain more convincingly how the concentration in the audit market is affecting market competition.

The Appraisal finds that the policy options presented in the Impact Assessment are clear and well-structured, but is concerned that in certain cases the preferred options are costly and opposed by the majority of stakeholders. In particular, that there is little evidence to support the concepts of Mandatory Rotation and the provision of Non-Audit Services and that it is therefore doubtful that the Commission has presented a range of options proportionate to the identified problem.

The Appraisal concludes with a summary to the identified weaknesses of the Impact Assessment:

37 Known as the ‘big four’ – Deloitte Touche Tohmatsu, Ernest & Young, KPMG, PwC.
Without making judgement on the substance or the value of the policy proposals tabled by the Commission, from a methodological point of view, the Impact Assessment fails in part to provide solid evidence for certain claimed problems. Both these and the underlying drivers for the proposed policy change should be more clearly demonstrated. The Impact Assessment should also provide a more solid justification for some of the policy options chosen, stronger justification for why certain other options have been rejected, and a more detailed assessment of the likely costs and benefits of the specific measures envisaged, if that is possible (Ballon & Georgescu, 2012).
4 Methodology

The choice of method of research is very important and must be made deliberately with regard for the circumstances and objectives of the study (Arksey & Knight, 1999). This research study is based on the analysis of two types of data; existing data in the form of responses to the questions asked by the Green Paper of 2010, and interviews conducted subsequent to the analysis of the existing data. In that sense, a hypothesis was built on the results of the initial analysis. Interviews were subsequently used in order to support or dispute that hypothesis and to give further insight into the discoveries.

The responses to the Green Paper were downloaded from the EU website in September 2011\(^{38}\). Of the 688 responses, sample sizes from the different categories of respondents were calculated, and the chosen samples analysed through the process of ‘content analysis’. Content analysis can be described as “a research technique for making replicable and valid inferences from texts (or other meaningful matter) to the contexts of their use” (Krippendorff, 2004). This analysis was performed with the use of a series of charts, coding the information and arriving at a somewhat quantified result, in order to establish the hypothesis and to display the findings in graphic form.

The overall approach of this research is however qualitative. Qualitative methods give the researcher the opportunity to explore the results, and to provide a greater understanding of the issues (Silverman, 2001). The responses were therefore also examined qualitatively in order to gain insight into the attitudes of the respondents and to the reasons behind their opinions.

In making the decision to conduct interviews, the concept of ‘data triangulation’ was taken into consideration. The term “triangulation” was initially used in surveying, military strategy and navigation to describe a technique whereby two known landmarks or reference points were used to define the position of a third (Arksey & Knight, 1999). Webb et al. (Webb, Campbell, Schwartz, & Sechrest, 1966) said “It is through

\(^{38}\) Downloaded from http://ec.europa.eu/internal_market/auditing/reform/index_en.htm#new
triangulation of data procured from different measurement classes that the investigator can most effectively strip of plausibility rival explanations for his comparisons.” Data Triangulation can be used in its role of testing the truthfulness of a hypothesis, although it does not rule out the possibility that the additional results may not support the initial findings, a situation referred to as ‘diversity in findings’ (Arksey & Knight, 1999).

A series of 6 interviews were conducted in August and September 2012. Five of these interviews were carried out in Icelandic and one in English. They were recorded in digital form and transcribed word for word (translated into English in the case of the Icelandic Interviews) in order that the text could be analysed thoroughly, the content coded and the inferences drawn on the presented issues. The interviews were semi-structured, focusing the discussion on the relevant issues, and ensuring the efficiency in the triangulation process.

Content analysis is a scientific tool, but is only effective if the techniques involved are reliable (Krippendorff, 2004). The responses which were analysed are available from the European Union website and the coding of the analysis of the interviews is demonstrated in the appendices. The researcher believes the data used and the analytical processes performed have ensured a robust research project.

4.1 The Sample of Responses

“A sample is said to be representative of a population if studying it leads to conclusions that are approximately the same as those that one would reach be studying the entire population.” (Krippendorff, 2004). Ideally, a researcher would want to analyse the content of every item of data, however, it is often the case that there is simply too much data to be able to achieve that. The researcher, therefore, needs to gain an understanding of the views of an entire population by analysing a selection of the given data. Selecting the appropriate amount of data (sample size) for analysis is key to justifying the findings and not biasing the results. The relationship between the sample size and the reliability of the results is not linear, rather as the sample size reaches a critical level, further samples provide little additional comfort. The researcher will decide on an acceptable level of reliability in findings and calculate the sample size accordingly.
When analysing texts, it is rare that each unit will have equal relevance to the research question and it is only in the case that all of the data is equally relevant that sampling in content analysis can be considered the same as sampling in survey research. In this case, the texts in the form of responses to the Green Paper are all responding to the same questions and therefore are equally relevant. This research, therefore, looks toward ‘statistical sampling’, in the form of ‘probability sampling’, which is designed to ensure that each unit of data has an equal chance of being included in the sample (Krippendorff, 2004). Under the heading of ‘probability sampling’ are three available methods, ‘random sampling’, ‘systematic sampling’ or ‘stratified sampling’.

The Green Paper received 688 responses, divided between the different areas of the interest groups (European Commission, 2011). The nature of this structure of responses makes the ‘stratified sampling’ method the relevant choice. Stratified sampling recognises sub-populations within the main population and the researcher arrives at a sample size, proportionate to the size of the sub-population, of random samples from each.

The interest groups presented in the following table are considered the sub-populations of the main population. For the purpose of this study, the sampling will focus on the relevant sub-groups within the population; those groups that have been identified as representing the ‘relevant bodies’ throughout this paper. No samples will be taken from the other sub-groups. In order to calculate the sample size for the given portion of the population, there are four conditions that need to be specified. These conditions are shown here along with the assessed values given to each:

- The margin of acceptable error – 10%
- The required confidence level – 90%
- The response distribution – 50%
- The population size – shown in table below

Given these conditions, the sample size was calculated and can be seen in the following table, along with the distribution of the responses. These samples were then
chosen at random from the given groups using the role of a dice to proceed from one response to the next.

Table 5. Number of responses to the Green Paper from the relevant interest groups, and sample size for analysis.

<table>
<thead>
<tr>
<th>Sub-population/Interest Group</th>
<th>Number of Responses</th>
<th>Sample size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit Profession</td>
<td>407</td>
<td>59</td>
</tr>
<tr>
<td>Preparers/Corporation</td>
<td>145</td>
<td>47</td>
</tr>
<tr>
<td>Users/Investors</td>
<td>22</td>
<td>17</td>
</tr>
</tbody>
</table>

4.2 Interview Participants

For the purpose of this research 6 people representing the different Relevant Bodies were chosen. Interviewees A1 and A2 are practicing auditors, U1 and U2 are working in investment banking and represent the view of both the preparer and the investor. The remaining two, P1 and P2 are involved in public oversight. This can be seen clearly in the following table.

Table 6. Interviewees

<table>
<thead>
<tr>
<th>Key</th>
<th>Relevant Position in the Economic System</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1</td>
<td>Auditor</td>
<td>Certified Public Accountant/Auditor</td>
</tr>
<tr>
<td>A2</td>
<td>Auditor</td>
<td>Certified Public Accountant/Auditor</td>
</tr>
<tr>
<td>U1</td>
<td>Corporate, financial institution</td>
<td>MBA. Experience of working with corporate debt management, presently working in investment banking</td>
</tr>
<tr>
<td>U2</td>
<td>Corporate, financial institution</td>
<td>Qualified auditor with experience of working in audit firms, now working in investment banking</td>
</tr>
<tr>
<td>P1</td>
<td>Public Oversight</td>
<td>Experience of working in large financial institutions, now working in Public Oversight</td>
</tr>
<tr>
<td>P2</td>
<td>Public Oversight</td>
<td>Qualified auditor now working in Public Oversight</td>
</tr>
</tbody>
</table>
4.3 Limitations of the Research

There are conditions of this research which could affect the reliability of the results. Firstly, when choosing samples from the responses, a large number are not available in English. Therefore the method of moving from one sample to the next was not entirely accurate. The researcher believes however, that due to the overwhelming nature of the results, the sample examined from that part of the research accurately portrays the feelings of the entire population.

Secondly, it should be noted that the responses largely represent the larger Member States of the EU, whereas the interviews were taken in Iceland, a country of only 320 thousand residents. Due to the nature of such a small environment, it can be difficult and often impractical to achieve the same degree of independence within the professional environment as is expected in larger countries. It is possible that this has had an influence on the attitudes of the individuals interviewed. Certainly, if this research were to be repeated, it would be interesting to conduct interviews with professionals from the larger Member States in the EU.

Having said that, the professionals interviewed in Iceland are fully aware of conditions in larger states and have experience of working abroad. The laws by which these individuals operate are implemented as a result of directives and regulations from the European Union; the legislative environment is therefore very similar.
5 Results

The findings of analysis of the responses and of the interviews are presented here respectively. When considering professional scepticism, especially from the view of the respondents of the Green Paper, it is important to appreciate that everyone considers professional scepticism to be important for a quality audit. The following results, in this regard, are therefore not attempting to show those in support or against the reinforcement of professional scepticism, but rather those who support or object to this being done through further legislation.

Analysis of the responses is displayed not only qualitatively, but also quantitatively in order to clearly demonstrate the results.

5.1 Results According to the Responses to the Green Paper

5.1.1 Regarding Professional Scepticism

All of the responses to this question agree that professional scepticism is essential to the effective performance of the auditor. There are differences of opinion as to whether it needs reinforcing and to the way in which it should be reinforced. Respondents responding in a more negative way are not in fact against the reinforcement of professional scepticism, they simply do not agree on how it should be done. They suggest that, as professional scepticism is clearly demanded by the ISAs and the Code of Ethics, it would seem more appropriate to enforce the use of these standards, rather than introduce new legislation.

One of the responses from a member of the audit profession against the implementation of further legislation states:

Professional scepticism is mainly a result of the auditor’s understanding of the client and its environment. Subjective assessments, as such, cannot be reinforced from the outside or regulated by the law (Consiglio Nazionale Dei Dottori Commercialisti E Degli Esperti Contabili, 2010).

Analysis of the responses of the audit profession reveals the results seen in this chart.
KPMG International (2010) supports this view. They recognise that professional scepticism is about behaviour and that auditors need to continually reinforce this in their mind-set, but do not believe that the introduction of more rules is the right answer. They feel that the ISAs are sufficient on the requirements in this area. Further support of this is seen in the response from Ernst & Young (2010) who feel that the adoption of the ISAs for all statutory audits would be a better solution. Making reference to the definition of professional scepticism in the ISAs, they “do not believe that auditors need to perform their work based on a new, more stringent interpretation of professional scepticism”. It is clear that these respondents feel it unnecessary for the EU to enforce professional scepticism when the ISAs are so clear on the requirements and that more effort should be put into enforcing the use of these standards.

There are however respondents who believe further legislation is the right answer. The Association of British Insurers (2010) point out that there is the risk that auditors are more concerned with finding evidence to corroborate the information put forward by management, rather than with challenging the accounting figures. They feel that this needs to be addressed with efforts to reinforce professional scepticism by the regulators, and not solely through the professional standards. The Investment Management Association (2010) completely agrees with this, going so far as to suggest that “what management has done and the auditors accepted may not be material to whether the financial statements are fairly stated overall”. They are particularly
concerned by recognised cases where the same financial instruments were valued at different amounts by different organisations even when these organisations had the same auditor. This points to the fact that the auditors are simply agreeing with the figures which management puts forwards without demonstrating scepticism. It is therefore likely that the only way to enforce that professional scepticism is in place is to legislate it:

Incumbent in being appropriately sceptical should also have a clear sense of legal purpose. Rule of law rather than rule of standards should apply (Local Authority Pension Fund Forum, 2010).

It is the investor who is most clearly in support of more legislation from the EU regarding professional scepticism. Their opinion can be seen in the following chart.

Chart 2. The position of the investor regarding the reinforcement of professional scepticism through additional legislation from the EU.

In general the investor feels that auditors need to behave more professionally when carrying out an audit. They feel that auditors accept information provided by management without questioning its integrity. Abma (2011) says, the investor expects that the auditor realise that, although they work for private firms, they have a duty to serve the public interest, and in order to do this they need to conduct themselves with a questioning mind and demonstrate professional scepticism. Abma agrees with the European Commission’s opinion that professional scepticism plays an important role in the detection and prevention of fraud. The investor feels that it is in the area of professional scepticism that improvements can be made, improvements that would
almost certainly have a positive effect on the reliability of the published financial statements. The CFA Institute (2010) included in its response:

The Green Paper’s discussion on the concept of professional scepticism that is the auditor challenging the management from the user’s perspective is refreshing and commendable.

Professional scepticism is a “state of mind” making it a difficult concept to reinforce through legislation. However, the procedures followed in performing an audit are documented in an audit file. An inspection of the audit file should reveal evidence of the use of professional scepticism by the auditor. The lack of direct legislation in this area means that there are no consequences for the auditor who does not demonstrate enough professional scepticism. This is the view of Business Europe (2010) who believe that audit regulators should be able to refer an auditor, who fails to act with professional scepticism, to a disciplinary tribunal.

There are respondents who believe that this documentation should be taken one step further and that there should be increased communication by the auditor, on his doubts concerning the information published by the entity (The French Professional Institute of Chartered Accountants, 2010). In this sense, the auditor would be more committed to documenting his attitude towards professional scepticism, therefore contributing to more investor trust and reducing the “expectation gap”. The Chartered Accountants Regulatory Board (2010) supports this view, saying:

One of the ways professional scepticism is in fact evidenced is through qualifications in the audit report. Such qualifications are, by nature, seen to be negative. This negative perception could be addressed by providing more detailed information in the audit report.

The Confederation of Swedish Enterprise (2010) also supports the view that professional scepticism should be adequately disclosed, but they feel that any reinforcement should be carried out by supervisory bodies and not the EU.

This is representative of some of the attitudes of the corporation. The following chart shows the distribution of the responses.
The idea of increased communication and disclosure does indeed have a fair amount of support overall, but there is the worry that this could involve the auditor having to work through a check-list in order to show that his audit was carried out with the required amount of professional scepticism. Again, as professional scepticism is a ‘state of mind’, it is difficult to see how this check-the-box attitude would produce the required evidence (Belgian Institute of Registered Auditors, 2010). Another way of looking at it is to consider that professional scepticism should rely on a qualitative assessment of the environment. A check-list approach would require more of a quantitative calculation. Such rigid regulatory environments and audit approaches could lead to an unthinking attitude and be a disincentive for auditors to be sceptical (Institute of Chartered Accountants in England and Wales, 2010).

Although most of the respondents agree that professional scepticism should be reinforced, whether it be through enforced use of the ISAs or through further legislation from the EU, there are some who believe that auditors are already acting with sufficient professional scepticism and that reinforcement is therefore unnecessary. Kingston Smith (2010b) is convinced that the auditor was not at fault in the lead up to the most recent banking crisis and that there is no need to query the level of scepticism exercised by the audit profession. Consistent with this response, the response from Barclays Financial Control says:
We are not aware of any lack of professional scepticism on the part of the auditors. We believe that the audit profession is sufficiently regulated, including through the application of professional standards, to ensure performance in this regard (Lucas, 2010).

The Confederation of British Industry (2010) points out that there are few cases of audit failure in the United Kingdom. This demonstrates that the audit system is working well and there is no apparent need for professional scepticism to be reinforced. The British Bankers' Association (2010) agrees with this.

5.1.2 Regarding Mandatory Rotation
When examining the responses concerning the mandatory rotation of audit firm, it is clear that an overwhelming percentage from the three interest groups are opposed to the idea. It is this which gives rise to the question of whether the legislator is ‘going too far’, and raises the question of whether there is a divide between the legislator and the audit profession and whether the attitude of the audit profession is markedly different from the attitude of the other groups.

The pie-chart here shows the distribution of the opinions demonstrated in the responses from the audit profession.

![Pie Chart: The position of the audit profession regarding mandatory rotation.](image)

Chart 4. The position of the audit profession regarding mandatory rotation.
Extensive research in this area\textsuperscript{39} has failed to show that rotating the audit firm, rather than the audit partner, would improve the audit system. This is exactly the point that Deloitte Belgium (2010) is making when they say:

We do not believe that the continuous engagement of audit firms should be limited in time, nor are we aware of any evidence that supports the position that this would enhance audit quality.

This is emphasised by the opinion of the Institute of Chartered Accountants in England and Wales (2010) who refer to the fact that in the countries where such a system has been in place, it has “not been a success”. The International Federation of Accountants (2010) also feel that mandatory rotation is not a good idea. They point out that substantially all research shows that such a system is not beneficial to the audit and can, in fact, undermine audit quality. It would seem, from the responses overall, that there is concern that the EU should even consider introducing mandatory firm rotation, when all of the evidence and practical experience shows that the system does not work.

This opinion is not limited to the audit profession, members of the other relevant bodies feel the same way. On behalf of the corporation, Cofina SGPS (2010) agrees, saying:

We understand that there is no empiric or proved evidence that the artificial imposition of a limitation on auditors mandate would bring an increase in the quality of the audit process, nor a resolution of any independence threats.

Cofina SGPS continues, pointing out that the existing system of audit firm rotation in Italy has not prevented the occurrence of audit failures. The overall distribution of the opinions of the corporation can be seen in the following chart.

\textsuperscript{39} See Section 2.1.3 Mandatory Rotation
The idea that it is the right of the shareholders to choose the auditor is also at risk if a system of mandatory firm rotation were to be introduced. Deloitte Belgium (2010) feels that enforcing this rotation would strip the shareholders of that right. The French Professional Institute of Chartered Accountants (2010) also comments on this saying:

In public-interest entities, the renewal of an auditor is approved of by the shareholders in general assembly on the basis of a recommendation by the audit committee; against such background it is not advisable that the rights of shareholders be reduced by a legal provision.

If the investor is considered to be the member of the relevant bodies with the most at stake, one may expect their responses to be more in support of the proposal for mandatory rotation. In fact, the investor is as much against as the audit profession and the corporation. This can be seen in the following chart.

Chart 5. The position of the corporation regarding mandatory rotation.
The investor makes the same argument as the other bodies, with diminished shareholder rights an obvious issue. As the Association of Pension Funds Management Companies (2010) says, “should the entity be forced to rotate the auditor (firm), it will effectively be considered the same as not being able to appoint the auditor of their preference”. Abma (2011) agrees, saying that it should be the General Meeting of the Shareholders who have the right to approve the choice of auditor.

One of the major points made by the research carried out into mandatory rotation concerns the additional costs that the introduction of such a system would entail. This issue is a concern for the vast majority of respondents. Deloitte makes reference to research carried out by the Bocconi University in Italy (Dallocchio, 2005), the only Member State to have a system of rotation in force. This research finds that the costs involved in the first year of an audit engagement are very high, both internal costs of the time taken by management and staff in explaining business processes, and the external cost incurred by a reduction in audit quality. Kingston Smith (2010b) supports this view saying:

To enforce mandatory rotation would be another restriction on how businesses conduct their affairs and indeed lead to increased costs for businesses as a result of the knowledge gap that incoming auditors would inevitably have.
ConocoPhillips (2010) also comments on the extra costs involved during the initial years of a new audit engagement. They feel that the hours an audited entity spends internally to bring the newly rotated firm “up to speed” are costs that are unnecessary and are ultimately borne by the company’s shareholders. In their opinion, these are extra costs without any perceived benefits. From this response, amongst others, it seems clear that the attitude of the respondents would be different if they could see any benefit to a system of mandatory rotation. They would even be prepared to incur the additional costs if they believed that the result would be a higher quality audit. The existing evidence from research and from practical application show that this would not be the case.

The existing Statutory Audit Directive\textsuperscript{40} already requires that the audit partner of public-interest entities is rotated on a 7 year basis. This is considered by most of the respondents to be sufficient to address the risk of over-familiarity. The Belgian Institute of Registered Auditors (2010) points out that the Directive is consistent with the IESBA\textsuperscript{41} Code of Ethics and that any other measures would be disproportionate\textsuperscript{42} to the objective. This again implies that the EU proposal in this area is unnecessary. The existing directive also makes demands for independent oversight and audit committee monitoring of the auditor’s independence. This is considered by many to provide the necessary additional safeguards against the risk of familiarity, but it is felt that the EU is not giving the Directive the chance to take effect. Deloitte Belgium (2010) and KPMG International (2010) do not believe that it is possible to judge the effectiveness of the provisions of the Directive, as it has only been implemented “for a couple of years”\textsuperscript{43}.

Perhaps the most convincing evidence that the provisions made in the Directive concerning partner rotation sufficiently safeguard the risk of familiarity can be seen in Austria. The law in Austria requires that the Austrian Savings Banks Audit Association carry out the statutory audit of all of the savings banks in Austria. They are also responsible for monitoring the financial stability and economic performance of the savings banks and for cooperating with the legally required monitoring and steering committees of the savings banks sector (The Austrian Savings Banks Audit Association,

\textsuperscript{40}Directive 2006/43/EC
\textsuperscript{41}The International Ethics Standards Board for Accountants
\textsuperscript{42}See paragraph on the principles of subsidiarity and proportionality in Section 2.2 The Legislator
\textsuperscript{43}These responses were written in 2010.
2010). In this situation, audit firm rotation is not an option. Instead, they operate a system of internal auditor rotation similar to the requirements of the Directive. This system has proven itself to remove the threat of over-familiarity. The Austrian Savings Banks Audit Association believe that their system is evidence enough of the fact that firm rotation is unnecessary in that no Austrian savings bank was distressed during the most recent crisis and no Austrian savings bank was forced to apply for government aid to ensure their survival. Additional support to this is provided by the International Federation of Accountants (2010), who say:

...the commonly applied public sector practice of the appointment of a single audit organization in perpetuity also suggests that auditor (firm) rotation is not essential to audit quality.

Of the responses analysed, there are 4 which seem unable to commit themselves to either support or oppose the proposal. They try to take an objective stance, pointing out the advantages and disadvantages. The Dutch Association of Issuers (2010) says:

The trade-off here is between independence and the loss of understanding and knowledge of the audit-client when the audit firm changes... Currently audit partners are rotated every 6 years, which ensures sufficient independence at a personal/individual level.

From this paragraph it could be argued that they are against the idea of audit firm rotation and feel that the 6 year partner rotation, which is similar to the demands of the Directive, to be a better option. However, their response continues, saying that “if a mandatory rotation were to be considered, it should in any case take place after a substantially longer period than 7 years”. The RSM-CCI Conseils (2010) voices a similar opinion, first admitting that they do not see the length of engagement as a major risk, but subsequently saying that a period of 5 to 6 years, renewable once, would be an appropriate mandatory rotation period. The inconsistency of these responses makes it difficult to assess them as either for or against.

As can be seen in the pie-charts, there is limited support for the proposal of mandatory rotation. There are, however, respondents who believe that auditors currently stay in place too long, threatening their independence (Hermes Equity Ownership Services, 2010). Ferraz (2010) and The Slovenian Institute of Auditors (2010) believe that mandatory audit firm rotation would reduce this threat. Ferraz also feels
that “new people doing an audit see the audited entity through new eyes, from a new perspective and have a new attitude towards assessment”. This implies that a new auditor may be more willing to look at the audited entity through sceptical eyes, and base assessment on objective information, rather than on the same habitual methods as have previously been used.

If mandatory rotation were to be introduced, against the wishes of the vast majority of respondents, there is the question of how long the engagement should be. From those responses that were uncommitted the suggestions were from 5 to 7 years. If renewable once, the engagement time would double. The time limit suggested by the European Commission is anywhere from 2 years up to 12 depending on the circumstances\(^\text{44}\). In most cases this would in fact be either 8 years, or 12 years, depending on whether the entity is audited by one or two audit firms\(^\text{45}\). The supporters suggest periods of 5 years (Danish Shareholders Association, 2010), or even 4 years (Slovak Association of Finance and Treasury, 2010). These engagement periods could be considered shorter than those suggested by the EU leaving the feeling that the supporters are rather determined in their support.

\(^{44}\) See Section 3.3.2 The Regulation Concerning Mandatory Rotation

\(^{45}\) The idea that public interest entities be audited by two audit firms is also discussed in the Green Paper.
5.1.3 Regarding the Provision of Non-Audit Services

Once again, it is clear when examining the responses from the different interest groups that the majority of people are against the idea of banning the provision of non-audit services.

In the extreme, the banning of the provision of NAS could result in the evolution of ‘pure audit firms’. This is a major concern to the respondents. PricewaterhouseCooper (2010) begins its response:

Whatever further steps are considered in relation to non-audit services for audit clients, the provision by audit firms of NAS to non-audit clients should not be prohibited. We strongly believe that creating ‘pure audit firms’ by prohibiting NAS would have an adverse effect on the quality of audit work and on the long-term sustainability of the auditing profession.

The problem of ‘pure audit firms’, as expressed in the responses, is that they would not have the essential knowledge and expertise that they gain from being permitted to provide other services. As Deloitte Belgium (2010) says:

Complex audits require the expertise and competencies of multi-disciplinary teams (including, e.g. actuaries and information system specialists) who are up-to-date with market techniques. These teams can simply not be maintained through audit-only experience.

Transactions and financial environments are ever becoming more complex. It is not feasible that a single professional could possess the wealth of all the necessary skills (Mazars, 2010). This is supported by the view of The Nordic Federation of Accountants (2010) who believe that the skills offered by multi-disciplinary firms enhances the quality and efficiency of both the audit and the NAS. The overall balance of the responses from the audit profession can be seen in the following pie-chart.

---

46 See Section 3.3.3 The Regulation Concerning the Provision of Non-Audit Services
The opinion that audit firms need the expertise they gain through being permitted to provide NAS is not restricted to the audit profession. Dual Group (2010), speaking from the point of view of the corporation is also against the formation of ‘pure audit firms’. They do not see “any benefits in creating ‘audit-only firms’, indeed, quite the reverse”.

Auditors’ ability to operate within a multi-disciplinary organisation provides them with the specialist skills needed for the audit of complex businesses and allows them to attract and retain talent by offering a variety of work experience and career options.
Being able to offer a high quality audit relies on having a team of staff with the necessary abilities. PricewaterhouseCooper (2010) agrees that attracting these individuals would be more difficult in the case of too much restriction on the provision of NAS. They feel that the best applicants are looking for career offering a varied workload and a wide range of experience. They point out that it is important for the auditor to be able to deal with senior client management as an equal. Here, PwC are referring to the fact that the auditor has to have at least an equal degree of knowledge and experience as client management. Without this equality, the auditor is less able to challenge management decisions and assessments. This influences their willingness to demonstrate professional scepticism and effects communication with management. The CFA Institute (2010) disagrees, saying:

...we agree that auditors should be prohibited from providing NAS to the firms they audit. It is difficult to exert professional scepticism on one hand and seek to extend the business relationship with the other. This restriction should apply to all members of the audit firm’s network.

This is a view fully supported by the Danish Shareholders Association (2010) and the Local Authority Pension Fund Forum (2010).

Overall though, respondents agree that audit firms need to be able to offer a certain degree of NAS, services which offer synergies, and would therefore be expected to enhance the knowledge and insights of the auditor and the overall audit quality (Aviva, 2010; Railpen, 2010). This is also backed by the fact that “it is very seldom proved to be a problem and the companies have to report what type of services the audit firm in question renders to the company” (Swedish Shareholders' Association, 2010). The Nordic Federation of Accountants (2010) points out that there appears to be no evidence to support the theory that an overall ban on the provision of ‘all NAS’ would increase auditor independence. OvRAN (2010) disagree with this, saying that the provision of NAS by audit firms should be limited in all cases, as it “undermines independence”. They continue to say that the banning of NAS should have been implemented “long ago in every country”. Another response agrees that audit and non-audit services should be kept separate, and that NAS should at least be banned for listed companies and public-interest entities (The HTM Auditors Association, 2011).
The majority of respondents feel, however, that there is already sufficient legislation to govern the extent to which NAS are permitted. As the Chamber of Auditors of the Czech Republic (2010) says:

Already today, there are a number of activities whose performance is prohibited to auditors, and activities that must not be provided to the accounting entity in which the auditor performs the statutory audit. We believe, therefore, that it is not advisable further to tighten the ban on the provision of NAS.

This is the view which is also largely supported by the investor. BlackRock Inc. (2010) makes reference to Article 22 of the existing Directive, further saying that they believe NAS should be permitted when they are directly related to the audit and accounting expertise contained within the audit firm. Abma (2011) points out that the provision of such services does not necessarily give rise to additional conflict of interest. Support for this statement is again in the belief that the existing legislation is sufficient, and also in the role of the audit committee.

The results of the analysis of the responses from the Investor can be seen here:

![Chart 9. The position of the investor regarding the banning of the provision of non-audit services.](image)

The role of the audit committee further supports the arguments of those against more legislation. As Deloitte Belgium (2010) says:

---

47 As defined by Article 41 of Directive 2006/43/EC.
...for audits of public-interest entities, auditors must annually confirm their independence from the audited entity, disclose annually to the audit committee any additional services provided to the audited entity and discuss threats to their independence and the safeguards they have applied.

There are a number of respondents, however, who do not totally agree that the existing legislation, or the role of the audit committee, is sufficient. In particular, Nexia International (2010) believes “there should be a rebuttable presumption that audit firms only supply audit services to large listed and systemic risk companies”. They feel that if this is not the case, the audit committee should be required to justify the decision to allow the provision of any additional services.

5.1.4 Overall

The Code of Ethics for Professional Accountants and the International Standard on Auditing 200 both demand that an audit be exercised with professional scepticism. The respondents, from all the interest groups, agree that this is necessary. The dispute, however, is over how it should be enforced. Not everyone is agreed that there is a need for more professional scepticism; there does not appear to be evidence to support the theory that there was a lack of it surrounding the most recent financial crisis. Those who agree that it would be beneficial to reinforce professional scepticism are not all of the same mind when it comes to the method of reinforcement. It is generally accepted that the Code of Ethics and the ISAs do a good job of explaining the extent to which professional scepticism should be applied. The introduction of any new legislation would seem unnecessary, given that the same result could be achieved by enforcing the use of the existing Code and the ISAs.

The issue of mandatory rotation is more contested. The responses show that there is next to no support for the idea. They present strong arguments that are well based on the results of research and the experiences of such a system in Italy. Equally so, there is very limited support for the prohibition of the provision of non-audit services. On both

48 Article 21 of Directive 2006/43/EC requires that all Member States ensure that all statutory auditors and audit firms are subject to principles of professional ethics and Article 26 states that all Member States shall require statutory auditor and audit firms to carry out statutory audits in compliance with international auditing standards adopted by the Commission. At present, there is no EU legislation enforcing directly the use of the Code of Ethics for Professional Accountants as produced by the International Federation of Accountants and the Commission has not yet adopted the International Standards on Auditing produced by the International Auditing and Assurance Standards Board.
of these issues, there is slightly more support by the investor, possibly reflecting the fact that it is this group that is taking the risk when basing its decision on the information presented in the annual report. However, the support of the investor is still insignificant when compared to those opposed.

In spite of these opinions, which are so clearly against additional legislation on the latter two issues, the European Commission presented its Proposal for amendments to Directive 2006/43/EC and for the implementation of a Regulation, raising the question of why the Commission is pursuing such an aggressive approach which is so highly disputed by the profession, corporations and the people who use the financial statements. This presents the hypothesis that the European Union is going against the wishes of the relevant bodies, and exceeding their authority with insufficient regard for the principles of subsidiarity and proportionality.

5.2 Interview Results

5.2.1 In Support of EU Proposals

The European Commission has implied that changes to audit legislation are necessary in order to strengthen the audit process and make it more reliable. Intrinsic in this implication is the theory that the auditor was greatly responsible for the most recent financial crisis. This has recently been disputed by the European Parliament who find that there is no proven causal relationship between the way the auditor behaved and the crisis. With this in mind, the subjects of the interviews were asked for their opinion.

5.2.1.1 Is the Auditor Responsible for the Financial Crisis?

Interviewee P1 is convinced that the auditor played a large part in the crisis, reminding us that we only need to look at the relationship between Enron and Arthur Andersen to see how the actions of the auditor can prevent the true position of the company from being seen. P1 points out that if the Icelandic banks had been using small audit firms, they would never have been able to take things as far as they did, referring to their degree of leverage and scale. The banks gained credibility through the use of the large international audit firms. The banks, who were “lying on all counts”, with help from their auditors, were therefore able to convince the authorities that they were profitable, well capitalised and liquid, when in fact they weren’t.
U2 believes that although auditors were not solely responsible, they could see something was wrong and that things did not add up, but they did not stop and do something about it. They did not ask enough questions. The banks were lending to companies based on their audited financial statements, and the auditor who carried out the audit on these financial statements had not asked enough questions, and before you knew it you had a chain. Auditors behaved like this because they didn’t believe that it would ever lead to a crisis. A1 also admits that it is possible that some auditors did fail.

5.2.1.2 Does Professional Scepticism Need reinforcing?
When considering the question regarding the reinforcement of professional scepticism, P1 is very much in support, stating that auditors were not sceptical in the lead up to the crisis, particularly when it came to agreeing to the valuation of bank assets. They also said nothing about the formation of new companies, whose purpose was the buying of shares in the parent so that the parent did not own more than its allowed 10%. U2 supports this and says that auditors should have commented more on the number of loans to holding companies that had no assets or collateral, and also loans to related parties. They should be asking the question “are we sceptical enough?” U1 does not believe that auditors were sceptical enough. “Auditors were hiding behind the rules and regulations, particularly IFRS⁴⁹, and failed to point out the defects.” A2 suggests that auditors should indeed have been more sceptical, “it’s not that auditors were plotting with their clients, at least not intentionally, I just don’t believe that. Maybe they were just too trusting.”

5.2.1.3 The Prohibition of the Provision of Non-Audit Services
P1 is in favour of banning the provision of non-audit services, pointing out that in the lead up to the crisis in Iceland, it was two of the big international audit firms that audited the banks and provided all of the other services for them. How then, could the auditor conduct himself with professional scepticism when the person sitting next to him was working on other services for the audited bank. U2 agrees with this, stating that it was one of these audit firms that was “all around us”, auditing almost all of the listed companies as well as giving advisory services for them. U1 is absolutely in support

⁴⁹ International Financial Reporting Standards
of banning the provision of NAS, as long as they are well defined. With the changes made in 2010 to the law concerning financial institutions\textsuperscript{50}, the authorities took it to far, prohibiting the audit firm from carrying out related assurance engagements for the entity they are auditing. “We have one firm that does our audit and if we need accounting advice we go to someone else, it’s absolutely no problem” (U1). A1 comments on the fact that the practice of audit firms making the lowest offer because they know that they will make up the revenues with NAS is not right. Audit firms should, however be allowed to provide related assurance services for a maximum of 10% of the received revenues from the company.

5.2.1.4 Mandatory Rotation

U1 believes that mandatory rotation is fully appropriate because the relationship between management and the accounting team develops and there becomes more trust between them. The investor will appreciate a change of audit firm because they will understand that when a new firm takes over, “there is more digging”, there is a more thorough audit than a repeat audit would be. “It’s just a fact of life, you get a new job and you are all of a sudden on your toes”. P1 feels that it is obvious that mandatory rotation be enforced and is not afraid of the extra costs that would be incurred. “For listed companies it is very important because they are so open to market manipulation and it is therefore in the public interest”. We only need to look to the case of Enron and of the Icelandic banks to see this. U2 feels that mandatory rotation is good for the client and for the economic system, but recognises that it is expensive and that the system is not prepared to pay for it. The length of engagement therefore needs to be carefully considered:

It is expensive to change auditor because he needs to familiarise himself with the company, examine documents, talk to people etc. So it is both the auditor’s wage and the time the company spends on the auditor. We know that the client doesn’t want to pay more, because this extra cost would be transferred to the final consumer, and the consumer wants to be able to receive his product or service at a competitive rate. So that is the problem with rotating too often (U2).

U2 continues, stating that although it is healthy to rotate the audit firm, the engagement period may not be too short, a 7 or 8 year period would be appropriate. P2

\textsuperscript{50} Law no. 161 from 2002
agrees that if the engagement period is too short then the costs involved are too high and the quality of the audit can suffer. P2 feels that the 5 year audit firm rotation rule implemented by the changes in 2010 to the law regarding financial institutions goes too far, and that the engagement period should be around 10 years.

Interviewee A1 believes that mandatory rotation is positive in the public’s perception. The public could consider the existing legislation regarding audit partner rotation not sufficient as there is too much opportunity for communication between the old and new audit teams.

5.2.2 Against EU Proposals
Some of the interviewees feel that it was more than just the auditors who failed in the lead up to the crisis. U1 believes that auditors were working in conformity with the relevant standards and that is was rather the fault of the IFRS. “I don’t think the auditors could or should have done things differently in that respect. I think there were just defects in how you report profit and loss and, as a result, assets and liabilities” (U1).

5.2.2.1 Auditor Failure or IFRS Weakness?
U1 continues, “One of my big concerns is mark-to-market\textsuperscript{51}. I think that mark-to-market accounting increases volatility in the market and allows you to cash-in without cashing-in. Then when things go wrong, you are left hanging out to dry”. This is a substantial contributing factor to the whole financial crisis. A2 agrees with this and refers to valuation issues, especially concerning goodwill:

\begin{quote}
The biggest account balances in some of the companies that collapsed was goodwill...but it was bought and paid for. Companies were buying other companies for more than their book value, and the difference was goodwill. Then we were auditing and we saw that they had carried out an impairment test as they should have (A2).

Interviewee A2 continues, saying that the goodwill had been bought at that price because of management’s future expectations and it would have been impossible for the auditor to come along and say “how stupid are you, why did you pay so much for it?”
\end{quote}

\textsuperscript{51} The practice of recording assets and liabilities according to their fair market value as opposed to their book value.
A2 says, when it comes to impairment tests, it is always a matter of judgement. It is built on the expectations of management and the interest rates that they choose to use. It is possible to look at benchmarks and at similar companies, and use professional scepticism in making assessment of management expectations, but in the case of a company that has been growing year after year, and management expects continuing growth, the auditor is not in a position to dispute management’s expectations.

P2 refers to the fact that the Special Investigative Report mentions a few cases concerning the writing-off of receivables, and the whole question of management judgement that was accepted by the auditors, but that these discussions are all too influenced by the opportunity of hindsight. “If you put yourself in that position in January 2008, then you didn’t have the information that was available afterwards” (P2).

P2 feels that auditors were a part of a whole chain that failed. The responsibility is on management, the financial supervisory authorities and other governmental institutions and the auditors, both internal and external. A1 also feels that it was more than just auditors who failed, and does not feel that auditors alone could have prevented the crisis. “We also need to consider the system of oversight that potentially failed, the central bank, the financial supervisory authorities, internal auditors, managers agreeing loans and generally the whole system”.

P2 points out that auditors could not be expected to see ‘the whole picture’, and that the authorities should have taken more responsibility in this sense, as they had access to inside information of all of the financial institutions and therefore had the opportunity to see ‘the whole picture’. When auditors looked at the issues going on in society, and the fact that the authorities had recently declared\(^{52}\) the banking system to be in good shape, how could they be expected to arrive at a different conclusion to everyone else.

U2 says “you don’t just walk in to the board of directors and say ‘this isn’t right’. You have to have evidence”. U1 supports this saying that auditors could not have said anything even if they had wanted to:

---

\(^{52}\) In September 2008, the banks collapsed in the October.
If you consider a listed company which is reporting in compliance with the rules and regulations, reporting according to IFRS. If the auditor would try to criticise the reporting, he would be ‘booted out by the board of directors’.

A1 agrees with this:

It is conceivable that someone somewhere could have reacted in some way, but I am afraid, in the case of Iceland, that if the auditors had reacted and given a qualified opinion, then the shareholders would go after them.

According to both interviewee A1 and P2, giving a qualified opinion would have been the same as giving the bank a ‘death sentence’ and it would therefore be perceived as the auditor sending the bank into bankruptcy.

5.2.2.2 Professional Scepticism: Is More Legislation the Answer?

When considering whether auditors should have been more sceptical, A2 feels that auditors were carrying out their duties as well as they could, but they had the problems of the extreme numbers of related parties, which were very difficult to identify, and the problem that if management is out to deceive the auditor, they will more than likely succeed. A2 refers to the case of Enron, saying that even if you follow procedure completely, it is very difficult to detect fraud:

In the end it is always a question of ethics, because if a dishonest manager is intent on deceiving the auditor, he is likely to succeed, even if we have professional scepticism (A2).

A2 is not convinced that, even if the auditor had done more when auditing the banks, it would have led to a different result, concerning both the financial crisis and the individual audit opinions.

U2 points out the problems concerning the issue of ‘related parties’. The banks have registers of ‘business partners’, where all related parties should be registered, but when taking into consideration the sheer numbers of companies owned by the entrepreneurs, and their subsidiaries, it is so complicated that it is almost impossible to identify all of the connections.

The Green Paper is asking whether professional scepticism should be reinforced and if so, how. A1 believes that introducing more laws will not change anything, referring to the fact that America has been introducing more strict legislation, they have established
the PCAOB\textsuperscript{53} and implemented their own Standards on Auditing, and yet nothing has changed. A1 feels that it all comes down to the issue of morals and attitude. A2 agrees, stressing that an overload of legislation can simply be so complicated that there is not enough time to learn it properly, and that legislation can never be a substitute for ethical thinking.

Interviewee U2 believes that what is needed is a massive change of attitude:

...it’s like what someone was talking about in the coffee break this morning, about the time when every other airline pilot was drunk at work. It was like that, but now that would never happen. I think this is similar, you can change attitudes...(U2).

5.2.2.3 The Prohibition of the Provision of Non-Audit Services

Interviewee A1 does not support a complete ban on the provision of NAS:

Managers of companies are concerned with the drastic changes that are going on, from the auditor providing various other services such as help with bookkeeping and advice, to the situation where the auditor has become too separated from the entity, and when it comes to performing the audit, he doesn’t know enough about the company to be able to carry out an efficient audit (A1).

A1 continues, saying that we need to be careful not to get into the situation where the auditor is only showing up in a company once or twice a year, and therefore does not know enough about the company.

U2 believes that the creation of ‘pure audit firms’ would reduce the overall knowledge of the audit firm and lead to a reduction in audit quality. Even informal conversations at lunch time help to maintain the knowledge that exists within the firm.

A2 believes that the European Commission is “going too far” and points out that if the proposed regulation is approved, the large audit firms would have to split into two firms. This would be very uneconomical, especially in smaller societies. A2 explains that they are very reliant on their specialists when carrying out an audit, because the auditors themselves do not have the necessary specialised knowledge. P2 agrees that when carrying out an audit, auditors look to the various departments within the audit

\textsuperscript{53} Public Company Accounting Oversight Board
firm for the specialised knowledge necessary and that the creation of pure audit firms would therefore be a problem.

A2 believes that the existing Code of Ethics is sufficient in stipulating how far an auditor or audit firm can go in providing non-audit services.

5.2.2.4 Mandatory Rotation

Interviewee A1 feels that a system of mandatory rotation would not work very well in a small community such as Iceland. The problem could be in finding a new audit firm which is not in some way connected to the entity and not already providing the entity with other services. P2 agrees with this, stressing that there are not many audit firms in Iceland with the necessary specialised knowledge to be able to audit the large financial institutions. P2 also points out that it is the larger companies which would be subject to mandatory rotation, and it is in the larger audit engagements that there is less likely to be a problem with independence. An audit team auditing a large institution consists of a number of auditors and a team of staff. It would be very difficult for one of the members of the team to be dishonest because of the difficulty of hiding it from the other members of the team. In this respect, it is the team itself which provides the necessary degree of security. In contrast, smaller engagements, with smaller audit teams would be more at risk. As far as interviewee A1 is concerned, the existing partner rotation is sufficient, also referring to the fact that the larger audit firms have their own internal rules and regulations which allow for not only the rotation of the key audit partner, but also of the team members.

A2 is concerned about the fact that research has shown that it is more likely for mistakes to be made when a new auditor takes over. This has to do with the lack of knowledge of the new auditor.

5.2.3 Comparison

It should be noted that there is a degree of overlap of the responses from the interviewees. Although some are very clear in their support or objection to the proposals, others state the advantages and disadvantages before arriving at a conclusion. U1, U2 and P1 show a general feeling of support for the proposals. P1 is absolutely convinced of the need for more legislation, being highly critical of the methods and attitudes of auditors. U1 and U2 are not as decisive as P1. U1 and U2
support the idea of the prohibition of the provision of NAS, as long as it is not taken too far, and does not lead to the formation of ‘pure audit firms’. They believe that the NAS need to be well defined. This therefore shows support for Article 10, paragraphs 1 to 4, but not for paragraph 5. A1, A2 and P2 do not support the proposals, stating that they will lead to a reduction in audit quality due to the loss of specialist knowledge within the company. They agree that auditors should not be able to supply all NAS to the clients they are auditing, but feel that the proposal goes too far. A2 finds no need for more legislation in this regard, as the guidelines set out by the Code of Ethics are sufficient.

When considering mandatory rotation, U1, U2 and P1 also show support and A1, A2 and P2 are against the idea. The supporters, however, point out the disadvantages of the period of rotation being too short. The extra costs involved and the initial loss of knowledge of the audit client means that the engagement needs to be long enough to make up for any reduction of audit quality during the first year. Those against find that these costs are too much, and that the existing system of partner rotation is enough to ensure the necessary independence.

Tables demonstrating this distribution of support and opposition can be seen in appendices at the end of this study.
6 Conclusion

This research set out to investigate the existence of a ‘divide’ between the auditor and the legislator. In order for this to be the case, however, the attitude of the auditor towards the legislator would need to be substantially different to the attitude of the remaining members of the Relevant Bodies towards the legislator. The results show that the ‘divide’ in question is not limited to the relationship between of auditor and the legislator, but also exists between the legislator and the remaining members of the Relevant Bodies.

The responses to the Green Paper are overwhelmingly against the implementation of more legislation. It is obvious that the European Commission, in designing the proposals for a new Regulation, did not sufficiently consider the opinion of the respondents, and proceeded with their proposals regardless. This view is supported by the European Parliament, who do not agree with the Commission’s proposals concerning the prohibition of the provision of NAS and the introduction of mandatory rotation. It would also seem that the European Commission has disregarded the findings of extensive research on the issue of mandatory rotation, research that clearly demonstrates the failings of such a system.

Analysis of the interviews shows a slightly different result, in that there appears to be an equal amount of support as opposition. Both supporters and those who oppose acknowledge the advantages and disadvantages of the proposals, but reach different conclusions when weighing the benefits against the costs. It is interesting to see that support is demonstrated by the interviewees who represent the preparer and the investor, whilst the two practicing auditors are more in opposition. This indicates the existence of a ‘divide’ between the legislator and the auditor, but when examined as a part of the research as a whole, is insufficient evidence. The fact that the interviewees representing the audit profession are against the proposals is not inconsistent with the findings of the analysis of the responses. The opinions of the interviewees representing the investor and the preparer are, however, inconsistent with the analysis of the
responses, suggesting that these participants are somehow influenced by the specific nature of their environment.

The consolidated results of this research do not suggest that there is a ‘divide’ between the auditor and the legislator, but rather that it is the European Commission who is not living up to the expectations of the relevant bodies. When looking for confirmation of the hypothesis that the European Commission is exceeding its authority with insufficient regard for the principle of subsidiarity and proportionality, the interviews are inconclusive. However, when taking into consideration both parts of the research, it seems very likely to be true.

6.1 Subsequent Legislative Developments
On 5th September 2012, the European Parliament’s Committee on Legal Affairs issued a draft report in which they amend the proposals made by the Commission (Committee on Legal Affairs, 2012). There is still a considerable process ahead before the final implementation of new legislation, but as it stands today, the Commission proposals have been reduced in intensity. This is almost certainly due to the overwhelming opposition voiced by the members of the financial market and criticisms that the European Parliament had of the Commission’s proposals and their assessment of the impact that the implementation of such proposals would have.

It therefore seems clear, that with their proposal for a regulation, the European Commission was proving the truthfulness of the hypothesis.
7 Discussion

When the Green Paper was released, there was a great deal of opposition to some of the proposals of the European Commission. There was an obvious divide between the audit profession and the legislator, but this was also reflected in the opinions of the other relevant bodies. Any approach of the legislator which was not consistent with the attitude of the audit profession, was also against the wishes of the majority of the respondents from the other interest groups.

The reason given for the audit profession opposition was that audit quality would suffer. The question is, does audit quality need to suffer? By investing more resources, audit firms could still guarantee the same level of efficiency. This however would mean either raising the bill to clients or accepting a reduction in profits. Clients are, of course, reluctant to pay more than necessary for their audit services, and a reduction in profits would make it harder for them to attract the high quality of staff necessary to carry out today’s complex and demanding audits.

Audit firms exist with an inherent conflict of interest. On one hand they are providing a public service and are expected to provide an honest and unbiased opinion, for the good of society. On the other hand, they are paid by the client, who can exert pressure on them, to supply an opinion that favours the audited entity. Changing this would require extreme legislative action. An alternative would be the formation of governmental audit institutions. Such a system exists in Austria and has successfully demonstrated its feasibility. Again though, it is hard to see how such audit bodies would be able to maintain a high level of professional staff without being able to offer incentives. This is an area in which further research would be, at least interesting, and almost certainly productive.

Auditors are required to conduct themselves with professional scepticism, and it is good for them to be reminded of this. Auditors do not dispute that, but dispute the idea that there needs to be more legislation in place to enforce it. It is possible that more legislation would not change anything, and that it is a mass change of attitude that is
needed. Could more legislation be somehow used, however, to trigger an attitude change?

Whether auditors are hiding behind the IFRS has been questioned. The auditor provides assurance that the financial statements are prepared in compliance with the relevant standards. There is, however, always the question of judgement and the application of professional scepticism. It is likely that, in the lead up to the financial crisis, auditors were not sceptical enough, especially when considering the valuation of the assets of the banks and of goodwill. Auditors follow specific procedures to assess management valuations, but should they consider more the concept of ‘substance over form’ as encouraged by the European mind-set, and be more prepared to step outside the procedures in order to provide a more accurate opinion?

It seems strange that auditors have been unable to stand up and say anything for fear of being “booted out by the board of directors” and certainly suggests a lack of direct action and oversight. Issues which are subject to judgement can easily be influenced by external forces, threatening the independence and objectivity of the auditor, coercing him into making favourable assessments. Even in the absence of fraud, judgements made by the auditor in a position of threatened independence can be damaging to the economy. This is the issue that the European Commission is attempting to solve, and it could be considered strange that not everyone supports this initiative. Isn’t everyone aiming for the same thing, a stable and reliable economic system? Although the costs of implementing the proposed changes could be high, the long term could offer a more stable environment from which everyone would benefit.

Both respondents and interviewees support the idea of improving audit reliability, but are overwhelmingly opposed to the use of more detailed and restrictive legislation to this end. The European Commission seems intent on making the auditing framework more and more ‘rule based’. This is inconsistent with the general direction of the European Union. Looking at accounting legislation, the EU supports a ‘substance over form’ and ‘principle based’ approach. This approach, which is the underlying ethos of the IFRS, allows the flexibility and use of judgement in the accounting for ever more complicated entities. Should audit legislation not follow this same path? Through the progression of audit legislation, more and more rules have been included, and yet, in
spite of this increase in legislation, major financial failures are still occurring; America is
evidence of this. It certainly seems that the EU is in a game of ‘tug of war’ with the
majority of the financial system, ‘stuck in a rut’ of muddy resolutions, pushing and
pushing, while the majority of the financial system is pushing in the opposite direction.

Iceland presents specific issues which should be considered. In such a small country,
is it possible to achieve the same degree of independence as is expected in larger
countries? Individuals who are expected to be professionally independent of each other
have often studied together, worked together and inadvertently socialise in the same
circles. People “bump into each other” on the street more regularly than could ever be
expected in larger communities. Without planning it, the auditor may find himself
playing golf on the same golf course as the management of the firm he is auditing.
Should the auditor remove himself from the audit assignment, or from the golf course?
What happens when the replacement auditor decides to play golf? The financial
institutions in Iceland are required to rotate their audit firm on a five year basis, and to
have their non-audit services performed by yet another audit firm. This presents an
impracticality, made even more difficult in the case that the bank manager enjoys golf.
Independence is key to the auditor’s objectivity in assessing the accuracy of the financial
statements. It is not enough for the auditor to feel independent, he has to be seen by
onlookers to be independent. Obviously, the auditor and the bank manager should not
play golf together, and they should not be connected through the same social circles.
This, however, accentuates the impracticalities existing within the small Icelandic
environment.

Fraud in financial reporting is a threat that is very difficult to detect, and it is far from
certain that implementing legislative changes will effectively target this problem.
Managers intent on committing fraud are likely to get away with it, whether the auditor
is professionally sceptical or not. Increased legislation surrounding auditor
independence will not necessarily change the attitude of the auditor, and will be
unlikely to tackle the problem of the individual ‘bad apple’ in the audit team or the
corrupt manager. Essentially it all comes down to the morals of the individual
participants and their ethical conduct, issues that are extremely difficult to influence
with the implementation of more and more legislation.
References


Luxembourg.

the Crisis.

2006/43/EC of the European Parliament and of the Council on Statutory Audits of
Annual Accounts and Consolidated Accounts, amending Council Directives

The French Professional Institute of Chartered Accountants. (2010). CSOEC Answers to
the Consultation of the European Commission.

Helsinki.

The Professional Oversight Board. (2012). *Key Facts and Trends in the Accountancy
Profession*. Financial Reporting Council Retrieved from

Policy.

U.S. Securities and Exchange Commission. (2003). *Amendment to General Statement of
Beneficial Ownership*. (SC 13D/A). Retrieved from

WorldCom's Former Chief Financial Officer, with Engaging in Multi-Billion Dollar
Financial Fraud Retrieved 15th April, 2013, from


Week, 8*(90), 7-7.

Witchel, A. (1995). AT LUNCH WITH: Elisabeth Maxwell; Questions Without Answers,
http://search.proquest.com/docview/430068335?accountid=28822

Østrup, F. (2010). The Danish Bank Crisis in a Transnational Perspective. *Danish Foreign Policy Yearbook*. 
## Appendices

### Timeline

<table>
<thead>
<tr>
<th>Year</th>
<th>Document Number</th>
<th>Title</th>
<th>Main Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1952</td>
<td></td>
<td>Treaty establishing the European Coal and Steel Community (ECSC)</td>
<td>Preserve the peace by monitoring the use of coal and steel.</td>
</tr>
<tr>
<td>1985</td>
<td>Com(85) 310</td>
<td>White Paper: Completing the Internal Market</td>
<td>Present objective of abolishing physical, technical and tax-related barriers to free movement within the community. Present objective to complete Internal Market (Single Market) within 7 years.</td>
</tr>
<tr>
<td>1986</td>
<td></td>
<td>Single European Act</td>
<td>Create a Single Market in the EEC.</td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td>Black Monday</td>
<td>Stock exchange crash.</td>
</tr>
<tr>
<td>1987</td>
<td></td>
<td>Various financial failures, incl. those due to fraud.</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td>Scandals of Robert Maxwell, Polly Peck and “Mani pulite”</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>Com(96) 338</td>
<td>Green Paper: The Role, the Position and the Liability of the Statutory Auditor within the EU</td>
<td>Respond to recent financial events. Achieve objectives set out in the</td>
</tr>
<tr>
<td>Year</td>
<td>Document Code</td>
<td>Document Title</td>
<td>Key Points</td>
</tr>
<tr>
<td>------</td>
<td>---------------</td>
<td>----------------</td>
<td>------------</td>
</tr>
<tr>
<td>1999</td>
<td>Treaty of Amsterdam</td>
<td></td>
<td>Amend, renumber and consolidate TEU and TEEC.</td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td>Collapse of Enron</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td>Meeting of ECOFIN council in Oviedo, Spain</td>
<td>Speedy adoption of recommendations concerning quality assurance and independence. Address issues of the provision of non-audit services and rotation of key audit partners. Stress importance of the implementation of auditing standards, the role of the audit committee and the adoption of a Code of Ethics. Consider the revision of the 8th Council Directive.</td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td>Collapse of WorldCom</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td>Financial Scandals of Parmalat and Royal Ahold</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>Com(2003) 286</td>
<td>Communication from the Commission to the Council and the European Parliament:</td>
<td>10 point action plan with short- and long-term objectives. Recognise the need to revise the</td>
</tr>
<tr>
<td>Year</td>
<td>Document Ref.</td>
<td>Title</td>
<td>Key Points</td>
</tr>
<tr>
<td>------</td>
<td>---------------</td>
<td>-------</td>
<td>------------</td>
</tr>
<tr>
<td>2011</td>
<td>Com(2011) 779</td>
<td>Proposal for a Regulation</td>
<td>Specific requirements regarding the statutory audit of PIEs.</td>
</tr>
<tr>
<td>2011</td>
<td>SEC(2011) 1384</td>
<td>Commission staff working paper Impact Assessment accompanying the proposal for a Directive and a Regulation</td>
<td>Assess the impact of the implementation of different legislative scenarios with different intensities.</td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td>Appraisal by the EP Impact Assessment Unit</td>
<td>Appraisal of the Commission proposals for a Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and for a regulation on specific requirements regarding the statutory audit of PIEs.</td>
</tr>
</tbody>
</table>
**Black Monday**
Black Monday refers to Monday 19\textsuperscript{th} October, 1987, when the Dow Jones Industrial Average fell more than 22% in a single day and resulted in a crash of the stock market (Browning, 2007).

**Robert Maxwell**
Robert Maxwell was a British media proprietor born in 1923 in Czechoslovakia (Rampton, 2007). After World War II, he worked in publishing and, with the help of his ever faithful wife, built up the company Pergamon Press (Witchel, 1995). Maxwell’s business activities were surrounded by controversy; in 1971 the Department of Trade and Industry state “Mr Maxwell... is not in our opinion a person who can be relied on to exercise proper stewardship of a publicly quoted company”. In spite of this, he continued in his business ventures, obtaining a controlling interest in the British Printing Corporation in 1980 and acquiring Mirror Group Newspapers in 1984. In 1988 he then acquired both Macmillan and Official Airlines Guides ("Mirror Group Newspapers plc: Investigations under Sections 432(2) and 442 of the Companies Act 1985," n.d.).

Following the acquisition of Macmillan Group, Maxwell experienced financial difficulties and began manipulating the market by buying shares through secretly owned foreign entities. In 1990 conditions continued to worsen and Maxwell began to use company pension funds in order to stabilise the Mirror Group and avoid bankruptcy ("Mirror Group Newspapers plc: Investigations under Sections 432(2) and 442 of the Companies Act 1985," n.d.).

In 1991, Maxwell died, having fallen overboard his yacht in the waters off the Canary Islands. His death is still shrouded in uncertainty (Witchel, 1995).

**Polly Peck**
Polly Peck was a small British clothing company, first incorporated as Polly Peck Holdings in 1959. The company expanded during the 1970s and diversified into the television, computer and electrical component market. In 1980, a Cypriot by the name of Asil Nadir acquired a controlling interest and in 1985, the company was renamed Polly Peck International Plc. The rapid growth, and the fact that the company relied heavily on Middle Eastern markets, lead to suspicion in investors. Although the
company continued to grow, share prices fell as investors became concerned at the company’s ability to pay its debts. In 1990 Polly Peck filed for bankruptcy, with debts of £1.3 billion. This received huge publicity and lead to an investigation by the Metropolitan Police and the Serious Fraud Office.

The investigation found that Asil Nadir had been transferring unauthorised funds out of the company bank accounts and registering company assets in his own name. The stolen funds amounted to more than £380 million and were used to buy shares in Nadir’s name and for his personal investment (Serious Fraud Office, 2012).

**Enron**

Enron Corporation was formed in 1985 from a merger of Houston Natural Gas and Internorth. Over the years to follow, Enron began to shift its focus from the regulated natural gas market to the unregulated energy side, also recognising the potential value in trading financial instruments linked to the energy market (Jickling, 2003).

Enron’s revenues grew at an extreme rate and in the 1990s they began to move towards the internet market, buying on-line marketers and service providers, and building a fibre optic network. Enron invested extensively in this area during the ‘dot com’ boom, leaving them with considerable debts. In 2000, the ‘dot com bubble’ burst, depriving Enron of the revenues they had expected from this investment. Enron had also invested significantly in foreign deregulated energy markets, but failed to capitalise on this due to local political policies (Jickling, 2003).

From 2000 onwards, Enron was experiencing considerable losses. Through fraudulent financial reporting, they managed to hide these losses and boost share prices. They created ‘special purpose entities’ whose sole purpose was to absorb the losses and acquire Enron’s valueless assets (Jickling, 2003). Enron’s shares reached an all-time high of $90.75 on 23rd August 2000 (Anderson, 2002).

In October 2001, Enron reported a loss for the first time in 4 years. The Securities and Exchange Commission (SEC), suspicious of Enron’s operations, requested information regarding certain related party transactions. At the end of October the SEC opened a formal investigation. In the November, Enron’s bonds were downgraded to ‘junk bond’ status and in the weeks following this, more than 5000 employees were laid off (Anderson, 2002). Enron released corrected accounting statements for the years 1997-
2001 which showed 80% less profits since 2000 than had previously been reported. Enron subsequently collapsed.

In the following investigations it was found that;

Enron’s auditor, Arthur Andersen, not only turned a blind eye to improper accounting practices, but was actively involved in devising complex financial structures and transactions that facilitated deception (Jickling, 2003).

**WorldCom**

WorldCom was a telecommunications company established in 1983 as Long Distance Discount Services Inc. Between the years 1989 and 1999 the company grew extensively and stock prices rose. In 1987 WorldCom merged with MCI Communications and became MCI WorldCom. In 2000 it was renamed simply WorldCom (Special Investigative Committee of the Board of Directors of WorldCom Inc., 2003).

Throughout the years 2000 and 2001, conditions for the telecommunications industry became increasingly difficult. In order to hide the true effect of the difficulties, WorldCom presented revenue growth information which omitted various charges and exchange rate effects. The growth shown was more than its competitors, but it was also more than was reflected in its official financial statements (Special Investigative Committee of the Board of Directors of WorldCom Inc., 2003).

In 2002, the internal auditors of WorldCom discovered that a total of $3.8 billion of expenses had been inappropriately capitalised. The Securities and Exchange Commission demanded that the financial statements for 2000 and 2001 be restated. Later that same year, WorldCom announced further accounting irregularities which amounted to a total overstatement of profits of more than $9 billion (U.S. Securities and Exchange Commission, 2003).

Following this announcement, on 27th June, 2002, the SEC filed its first civil enforcement action against WorldCom and shortly after, WorldCom filed for a Chapter 11 bankruptcy (U.S. Securities and Exchange Commission, 2004).

**Parmalat**

Parmalat, a small pasteurisation plant in Parma, was formed in 1961 by Italian, Calisto Tanzi. Over the following 20 years, Parmalat grew into a multinational corporation (Arie, 2004). In 1990, Parmalat went public and continued to expand. Between 1990 and
2003, Parmalat borrowed huge amounts of money to finance international acquisitions. However, these loans were backed by revenues from sales that did not all exist. From 1993 onwards, Parmalat began using fraudulent accounting methods to hide its growing losses in its subsidiaries with offshore companies created to absorb losses, and sales invented or billed twice. In 1999, the company’s auditor, Deloitte & Touche, filed an “early warning report” in which they expressed concerns. Between 1999 and 2003, more issues emerged and in March, 2003, other Deloitte partners questioned the legitimacy of intercompany transfers to the amount of $7 billion. In October, 2003, Deloitte Italy also had concerns about Parmalat’s financial reporting practices. In December 2003, Parmalat was forced to file for bankruptcy, and subsequent investigations discovered accounting fraud of around €14 billion (Gumbel, 2004).

**Royal Ahold**

The firm Ahold originated from a small grocery store, formed in 1887 by Albert Heijn, in Oostzaan, the Netherlands. The company expanded over the following years, quickly opening new stores, and was first listed on the Amsterdam Stock Exchange in 1948. Albert Heijn continued to expand, opening stores throughout the Netherlands. In 1973 the name was changed to Ahold N.V., an abbreviation of Albert Heijn Holdings. Soon after this, Ahold ventured overseas acquiring stores in Spain and the United States. In 1987, Ahold received the designation ‘Royal’ by Queen Beatrix of the Netherlands, in recognition of 100 years of business (Royal Ahold, n.d.).

In 2003, investigations by the regulatory authorities and Ahold’s auditors revealed accounting irregularities. Ahold announced that it would be restating its financial reports for the preceding 3 years (Royal Ahold, 2003). The restated statements showed significantly lower earnings than had previously been stated; share prices plummeted and Standard & Poor’s lowered the company’s credit rating to ‘junk bond’ status (Rankine, 2003). As a result of the investigations, law suits were filed against Ahold and its subsidiaries, and members of senior management faced fines and prison sentences (Taub, 2006).
**Mani pulite**

Mani pulite is the Italian for ‘clean hands’ and refers to an Italian investigation into political corruption during the 1990s. The corruption that was uncovered by these investigations was considerable and led to the suicide of a number of politicians and industry leaders. The corruption system is often referred to as Tangentopoli, in English ‘bribesville’ ("Mani pulite," n.d.).
## Coding

**Support for the Proposed Regulation**

<table>
<thead>
<tr>
<th>Support for the Proposed Regulation</th>
<th>U1</th>
<th>U2</th>
<th>P1</th>
<th>P2</th>
<th>A1</th>
<th>A2</th>
</tr>
</thead>
<tbody>
<tr>
<td>The auditor is largely responsible for the crisis</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Refers to Enron and Arthur Andersen</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks convinced authorities of their financial health through the auditors</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors failed to react</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors didn’t ask enough questions</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>It is possible that some auditors failed</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td><strong>Auditors were not sceptical enough</strong></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors did not question the formation of companies to buy share in themselves</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors were hiding behind IFRS</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Supports the prohibition of the provision of NAS</strong></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>...it leads to a lack of professional scepticism</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>The practice of making low offers in order to obtain NAS is not right</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td><strong>Believes mandatory rotation appropriate</strong></td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>There becomes too much trust</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>It is in the interest of the investor</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>More thorough audit with new auditor</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not concerned with the extra costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Good for the client and the economic system</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Length of engagement may not be too short</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>It is expensive but necessary</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Mandatory rotation positive in the public perception</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Against the Proposed Regulation</td>
<td>Interviewee</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>--------------------------------</td>
<td>-------------</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>U1</td>
<td>U2</td>
<td>P1</td>
<td>P2</td>
<td>A1</td>
<td>A2</td>
</tr>
<tr>
<td>The fault was in the IFRS</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Auditors couldn't have done things differently</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Concerned with mark-to-market</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Goodwill valuation was a problem</td>
<td></td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Writing off of receivables was a problem</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>...but information was not available until after the collapse</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td><strong>It was the whole system that failed</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management and supervisory authorities should take responsibility</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Auditors could not see the whole picture</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Auditors could not have said anything to the board of directors</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A qualified opinion would be the same as a death sentence</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Auditors were carrying out their duties as well as they could</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Problem with the extreme number of related parties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Difficult to detect fraud</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>More legislation is not the answer</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>It is a question of ethics</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td><strong>Does not support the prohibition of the provision of NAS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Managers are concerned that auditor will not know the company</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Auditor will not spend enough time in the company</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Would reduce the knowledge and expertise of the audit firm</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Would reduce audit quality</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The Code of Ethics is sufficient</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td><strong>Mandatory rotation would not work in small communities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Not enough specialised knowledge</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Not necessary because audit team is enough security</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Existing partner rotation is sufficient</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Research has shown that audit quality suffers in the first year of the engagement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>