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Mandatory Rotation of Audit Firms

A study on the investors' viewpoints in the EU and the US

Master thesis within Business Administration

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Abstract

Background

In 2010, the European Commission released a public consultation, Green Paper on Audit Policy, and a year later the Public Company Accounting Oversight Board in the US also published a public consultation, Concept Release on Auditor Independence and Audit Firm Rotation, which both included questions about whether mandatory rotation of audit firms should be implemented or not. The main suggestion in both public consultations was that the rotation would enhance auditor independence and increase audit quality. However, in 2013 the legislators in the US decided to prohibit a regulation on mandatory rotation of audit firms whereas the EU legislators, in 2014, decided to adopt the regulation to force public interest entities to change audit firms within a maximum period of ten years. These two different decisions by the EU legislators and the US legislators are interesting since they both wish to achieve the same purpose; to improve audit quality and auditor independence. Still, they used two approaches that are contradictory to each other.

Purpose

The purpose of this study is to examine and compare the replies from both EU investors and US investors in order to get their viewpoints about mandatory rotation of audit firms and to find out if the investors' viewpoints have had any impact on the legislators' decisions regarding the contradictory approaches in the EU and the US. The main research question is: Is there a difference between the investors' viewpoints of mandatory rotation of audit firms in the EU and the US?

Method

This thesis has studied the replies made by the investors to the Green Paper and the Concept Release, because investors are one of the primary stakeholders and those who should be most concerned with auditor independence and audit quality. The study consists of 42 replies, 22 replies to the Green Paper and 20 to the Concept Release.

Conclusion

The study shows that mandatory rotation of audit firms is not supported, according to the investors' viewpoints. A clear majority of the investors in the EU and all of the investors in the US opposed the rotation and similar arguments were used both by EU investors and US investors. The investors do not believe that regulations on mandatory rotation of audit firms will increase auditor independence or audit quality. The study further shows that legislators in the EU have not followed the investors' viewpoints when they decided to regulate the rotation in 2014. However, it does not show why the legislators decided on two different approaches, only that the decision by the legislators in the EU did not agree with the investors' point of view.

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Acronyms and Definitions

PCAOB – Public Company Accounting Oversight Board

AICPA – American Institute of Certified Public Accountants

EU – European Union

US – United States

US GAO – US General Accounting Office

SEC – Securities and Exchange Commission

Public Interest Entities

According to the Code of Ethics for Professional Accountants and the EU public interest entities are certain entities that may be of significant public interest because, as a result of their business, their size or their corporate status, they have a wide range of stakeholders. Also, public interest entities can be defined in a specific way by regulation or legislation in each country. Examples of public interest entities are: listed companies, credit institutions, insurance companies, and pension funds (IESBA, 2014; FEE Survey, 2014; Directive 2014/56/EU, 2014).

Public Company Accounting Oversight Board

The Public Company Accounting Oversight Board (PCAOB) is a US non-profit organization created through the implementation of the Sarbanes-Oxley Act of 2002 as a demand from the US Congress. The PCAOB oversees and investigates the audit industry in the US to protect the interests of investors and the public interest by suggesting improvements in terms of regulations, standards and directives. The Securities and Exchange Commission (SEC) has oversight authority over the PCAOB and selects the PCAOB's board members (PCAOB, 2015).

Audit Committee

An Audit Committee is a committee of members of the board of directors whose responsibilities include; to oversight the financial reporting process, selection of the independent auditor, receive audit results both internal and external, and ensure that auditors remain independent of management (Etzel, 2010).

Public consultation

A public consultation is a regulatory process which is seeking the opinions of interested and affected groups. Regulations affect all the participants in the society and a public consultation is a tool to improve quality in regulations. The objective is to gather information by the public in order to better assess the impacts of regulation and to minimize costs (OECD, 2015).

Concept Release

A concept release in the field of investment, finance, and economics is a public consultation published by the Securities and Exchange Commission, or one of the organizations they have oversight authority over, such as the PCAOB. The purpose of the concept release is to solicit the public's viewpoints before the actual announcement of a proposed rule or regulation (Etzel, 2010).

Green Paper

A green paper is a public consultation published by the European Commission with the purpose to stimulate discussion and receive arguments and standpoints by interested and affected groups. The Green Papers often includes proposals and ideas on how to change different areas within a particular topic at European level and invite the interested parties to participate in a consultation process. These papers are the first step in changing the law and it may lead to legislative developments that are later published in White Papers (Etzel, 2010).

I Introduction

I.1 Accounting Scandals

In the 1930s, two major accounting frauds were detected. In Europe, the Kreuger & Toll scandal was revealed. Kreuger & Toll offered loans to governments in exchange for exclusive rights to sell matches in their countries and financed these loans by selling stocks and bonds to US investors. It ended when no new investors could invest and the loan-takers could not pay back their loans, which resulted in that Kreuger & Toll ran out of money to pay dividends and repay their own loans (Clikeman, 2003). In the US, the McKesson & Robbins scandal was revealed. McKesson & Robbins had misstated inventory and accounts receivables, which the auditing firm Price Waterhouse (nowadays known as PwC) failed to detect during the audit. Due to these accounting frauds, studies and research on how to increase audit quality and auditor independence started in order to protect the investors from further scandals. After some time debating if the requirement that auditors must rotate clients could increase audit quality, audit partner rotation was introduced (Chi, Huang, Liao & Xie, 2009). As a consequence, the American Institute of Certified Public Accountants (AICPA) issued the first set of auditing standards, the main focus of which was the requirement that audit partners rotate their clients in order to increase audit quality (Chatfield & Vangermeersch, 1996).

In 2001 and 2002, two other significant accounting frauds were detected. The Enron scandal was revealed in 2001 and became the largest bankruptcy reorganization in American history and seen as the biggest audit failure of all time. Enron used special purpose entities along with inadequate financial reporting to hide billions of dollars in debt from failed deals and projects (Zellner & Forest, 2001). Following the bankruptcy of Enron the audit firm of Enron, Arthur Andersen, voluntarily surrendered its licenses to practice as auditors in the United States after being found guilty of the charges relating to the firm's handling of the auditing of Enron (Brown & Dugan, 2002). In 2002, the accounting frauds made by WorldCom was revealed. WorldCom had misstated their revenues and expenses to make the financial reports look better than what it actually was (Jeter, 2003). WorldCom had to file for bankruptcy, which made it the new largest bankruptcy in US history. Because of these scandals, the Sarbanes-Oxley Act was released in 2002, which is a federal law that should improve accuracy and reliability of disclosure made by entities. One of the headings in this act was about auditor independence. Notable changes that would increase auditor independence were the five year rotation of lead audit partner and the establishment of audit committees in companies' corporate governance, which main responsibility was to hire independent auditor and oversee the audit engagement (Sarbanes-Oxley Act, 2002).

I.2 Audit Rotation

Audit partner rotation was adopted in several countries from the 1940s and it still applies. However, in 1974 Italy chose to implement mandatory rotation of audit firms without anything to support this approach but the argument that it is an approach that had not been tried before (Hoyle, 1978). Italy still has mandatory audit firm rotation even though studies do not prove a clear positive effect but rather the opposite (Carcello & Nagy, 2004). In 1992, AICPA issued a report where they have studied if mandatory audit firm rotation could be better than mandatory audit partner rotation at increasing audit quality. It is concluded that there are many factors that would help increasing audit quality and enhancing auditor independence, but changing to mandatory rotation of audit firms is not one of these

factors (AICPA, 1992). The US General Accounting Office (US GAO) issued a report in 2003, which studies the potential effects that could occur if regulations regarding mandatory audit firm rotation were adopted. The main result of the study was that the costs of adopting regulations regarding mandatory audit firm rotation exceed the benefits. The regulations in the Sarbanes-Oxley Act, that was adopted to enhance auditor independence and increase audit quality, achieve the same result as regulations on mandatory audit firm rotation would have done. In addition, regulations on mandatory audit firm rotation would lead to more costly audits (US GAO, 2003).

Ever since the Sarbanes-Oxley Act of 2002 was released, the EU had worked on ways to enhance audit quality and auditor independence. In 2006, the EU adopted Directive 2006/43/EC on statutory audits, which was adopted to establish rules regarding statutory audits such as approval of statutory auditors, independence of the auditors, and audit quality (Directive 2006/43/EC, 2006). In 2010, the European Commission published a public consultation on audit policy, the “Green Paper on audit policy: Lessons from the crisis”. In this public consultation, the Commission questioned how the banks during the financial crisis from 2007 to 2009 were able to receive clean audit reports by their auditors even though the banks revealed huge losses during this period. The Commission raised questions about the current legislative framework and if it was needed to reform the audit policy. Some questions considered mandatory rotation of audit firms and according to the European Commission, some companies in Europe appoints the same audit firm for decades and the Commission believed that this might neglect the auditor’s independence and lead to further frauds and scandals. Even though the responsible audit partner has to be rotated at least every seven year by the Directive 2006/43/EC, the Commission argued that the familiarity threat of auditor independence still persisted. In order to reduce or eliminate this threat, the Commission wanted to examine advantages and disadvantages of mandatory rotation of audit firms by publishing the public consultation (European Commission, 2010).

In 2011, the Public Company Accounting Oversight Board (PCAOB) in the US also published a public consultation, the “Concept Release on Auditor Independence and Audit Firm Rotation”, regarding regulation on mandatory rotation of audit firms. The aim of the public consultation was to collect public viewpoints on how to enhance auditor independence and quality, and whether mandatory rotation of audit firms should be implemented. The main suggestion in the concept release was that mandatory rotation of audit firms would enhance auditor independence and increase audit quality. The public consultation included general questions about the mandatory rotation and questions regarding possible approaches to regulate mandatory audit firm rotation (PCAOB, 2011). However, in 2013, US legislators introduced a legislation, the Bill of Prohibition, which prohibits the PCAOB to issue law proposals on mandatory rotation of audit firms (Audit Integrity and Job Protection Act, 2013). In the meantime, the legislators of the EU decided to continue with the proposal of mandatory rotation of audit firms after the public consultation. In 2014, the legislators finally voted for the proposal and a new regulation and directive was implemented. The regulation included a mandatory rotation of audit firms for public interest entities and the principal rule to change audit firm within ten years, which is binding for all Member States (Regulation (EU) No 537/2014, 2014).

1.3 Problem

The discussion about audit quality and auditor independence relating to mandatory audit firm rotation is a highly current and interesting topic. The topic have been discussed by many instances and organizations and some of them believes that regulation is the right way to go while others are skeptical to regulations. The discussions about mandatory rotation of audit firms became intense after the public consultations in both the EU and the US. Many arguments and viewpoints about the rotation were given in the consultations, both supportive and unsupportive. However, in the end the legislators in the EU decided to adopt the regulations to force public interest entities to change audit firms after ten years, whereas the legislators in the US decided to prohibit a similar regulation. These two different decisions by the legislators in the EU and the US are interesting since they both wish to achieve the same purpose to improve audit quality and auditor independence, however, they use two approaches that are contradictory to each other. It makes it look like EU legislators believe that mandatory rotation of audit firms would enhance the audit quality and independence and that US legislators think that the rotation would instead impair audit quality and auditor independence.

The different decisions taken by the legislators in the EU and the US makes the audit regulation less harmonised between Europe and the US that could increase the ambiguity between stakeholders on these markets. It further raises questions about the competitive advantage in the global market if some countries forces their companies to rotate audit firm while companies in other countries can change audit firm whenever they like. The public consultations, the Green Paper and the Concept Release, should be considered by the legislators before implementing new regulations, which makes it relevant to study the replies to the consultations. Since the legislators in the EU and the US have had the same intended purpose with their different regulations it is interesting to see if they have considered any specific stakeholder in regards to their decisions. This study has its focus on the investor's perspective, which is further explained in the method section.

1.4 Purpose

The purpose of this study is to examine and compare the replies from both EU investors and US investors in order to get their viewpoints about mandatory rotation of audit firms and to find out if the investors' viewpoints have had any impact on the legislators' decisions regarding the contradictory approaches in the EU and the US. The replies are from the European Commission's Green Paper and the PCAOB's Concept Release.

1.5 Research Questions

Since this study has an investor's perspective and because the EU implemented regulations on mandatory rotation of audit firms even though the bill of prohibition was passed by US legislators the year before, the main research question is:

Is there a difference between the investors' viewpoints of mandatory rotation of audit firms in the EU and the US?

The EU Green Paper and the PCAOB Concept Release highlights audit quality and auditor independence and that an enhancement in these areas are necessary. They also suggests

that mandatory rotation of audit firms would improve those areas. With focus on the investor's perspective, the subsequent research question is:

Do the investors believe that regulations on mandatory rotation of audit firms will increase audit quality and/or auditor independence?

Because of the fact that the legislators in the EU and the US have chosen two contradictory approaches, the reasons to the opposite approaches are interesting to research. Therefore, the final research question is:

Have the investors' viewpoints and arguments had any impact on the legislators in the EU and the US when they decided to choose two opposite approaches when it comes to regulating mandatory rotation of audit firms?

2 Frame of Reference

2.1 Mandatory Rotation of Audit Firms

The US General Accounting Office (US GAO) conducted a study in 2003 on the potential effects of regulating mandatory rotation of audit firms where they summarized some arguments that either supported or opposed the regulations. The arguments for and against mandatory audit firm rotation concerned audit quality and auditor independence. Also, the matter of audit costs is an argument in the discussion regarding the subject. Those who support mandatory audit firm rotation mostly believe that the auditor independence will increase and that an auditor with a “fresh look” will deal with the financial reports more appropriate, while those who are against mandatory audit firm rotation believes that new auditors lack knowledge about the company’s business and that it would instead increase audit risk of audit failure. Those who oppose mandatory audit firm rotation also believe that it would increase costs and that increased costs together with increased audit risk outweigh the “fresh look” by a new audit firm, while those who support mandatory audit firm rotation believes that the “fresh look” will protect shareholders’ and other stakeholders’ interest so much that it outweighs the increased costs (US GAO, 2003).

Arel, Brody, & Pany (2005) further suggests other arguments that either supports or opposes mandatory rotation of audit firms. A supportive argument is that the relationship between the company and the audit firm could become to close and familiar that it affects the auditors independence and objectivity if the audit engagement is too long. An opposing argument is that the auditors independence would not be affected by a long relationship between the audit firm and the company. Instead it is a question of the auditor’s knowledge, professionalism, and integrity. The auditor’s knowledge, professionalism, and integrity maintains the enhanced independence. According to the authors, the outcome of the regulation on mandatory rotation of audit firms is uncertain. Studies show that the rotation could lead to lower audit quality in the first years of the audit, however, the auditor independence might appears to be stronger to external parties (Arel et al., 2005).

2.2 International Experience of Mandatory Rotation of Audit Firms

According to the study by the US GAO (2003), there are five countries that have or used to have mandatory rotation of audit firms: Italy, Brazil, Singapore, Spain, and Canada. In addition, there are six countries that have considered or discussed mandatory rotation of audit firms and these countries are United Kingdom, France, Austria, Netherlands, Japan, and Germany (US GAO, 2003; Ewelt-Knauer et al., 2012).

Italy has had mandatory rotation of audit firms, for public interest entities, since 1974 and the general rule is that the audit firm must be rotated after nine years. The main reason for Italy to adopt mandatory rotation of audit firms was to increase auditor independence to improve investor confidence. However, they have noticed audit fee pressures from large companies towards the audit firms that the audit fees have to be lower. The risk of a reduction in audit fees concerns the government in Italy since it might lead to decreasing audit quality. Spain had mandatory rotation of audit firms between 1989 and 1995 in order to increase auditor independence and to promote fair competition. However, it was abandoned in 1995 because they had achieved their goal on fair competition and argued that the regulation of mandatory audit firm rotation was not necessary anymore. Instead, they

adopted an audit team rotation for public interest entities in 2002, which means that the whole audit team has to rotate on a 7-year basis (US GAO, 2003).

Canada used to have mandatory rotation of audit firms within banking between 1923 and 1991. It was a special mandatory rotation of audit firms because it required joint audits by two audit firms and these two firms could not perform audits more than two consecutive years. Unfortunately, this did not work as planned since the banks instead only rotated with three audit firms but still had all three all the time. Hence, the legislators in Canada argued that the mandatory rotation of joint audits did not give a fresh perspective and it was abandoned in 1991 because the benefits of it did not exceed the costs. In 2003, audit partner rotation was introduced and is still believed to be sufficient in regulating the auditor independence. Brazil has had mandatory rotation of audit firms since 1999 and the general rule is a 5-year rotation. The main reason for Brazil to adopt mandatory rotation of audit firms was to have a better audit supervision because of two major accounting frauds at two banks. The legislators in Brazil do not believe in audit partner rotation because they believe that mandatory rotation of audit firms is better. However, they have a prohibition that the key audit partner cannot change audit firm and remain with the same client. Singapore has had mandatory rotation of audit firms only for banks since 2002 and the general rule is a 5-year rotation. The main reasons for Singapore to adopt mandatory audit firm rotation for banks was to increase auditor independence, increase auditor professionalism by not establish any long-term relationships, and give a fresh perspective to the audit process. Singapore has audit partner rotation for listed companies on a 5-year basis, which they argue is sufficient in regards to auditor independence (US GAO, 2003).

Austria was about to adopt mandatory rotation of audit firms in 2004 but chose not to implement it since they argue that the costs exceeded the benefits. In addition, Austria does not have any partner rotation but as Brazil they have a prohibition that the key audit partner cannot change audit firm and remain with the same client. The legislators of the United Kingdom have considered mandatory rotation of audit firms but came to the conclusion that it would reduce audit quality and effectiveness and also increase audit costs. Instead, they found that audit partner rotation is sufficient for auditor independence. In 2003 they changed the general rule of rotation from 7 years to 5 years. The legislators in France have considered mandatory rotation of audit firms but came to the same conclusion as the United Kingdom, that it would reduce audit quality. Further they added that the reduced quality would be due to the new auditor's lack of knowledge and competence about the company and its industry and business. Instead, France has had audit partner rotation since 1998 and since 2003 it was prohibited for an audit partner to sign more than six consecutive annual audit reports for the same client. Furthermore, they mentioned that joint audits could be an alternative to mandatory rotation of audit firms. In Germany they discussed and considered mandatory rotation of audit firms but concluded that independence is equally achieved by audit partner rotation and that their audit partner rotation is enough. They used to have an audit partner rotation with a special rule that the partner is prohibited to sign more than six of the latest ten annual audit reports, but now they have changed it to that the audit partner must rotate on a 7-year basis. Japan has considered mandatory rotation of audit firms but has chosen not to require it neither recommend it nor encourage public companies to adopt it. It is not supported because of four specific reasons: it would decrease audit quality; the new auditor would lack knowledge of the new clients' business and industry; it would increase audit costs; and it is not required in any other major country than Italy. Instead, Japan has had audit partner rotation since 2004 and the general rule is a 7-year rotation. The Netherlands has audit partner rotation and in 2003 they, just as Canada, changed the general rule from a 7-year rotation to a 5-year rotation. The audit partner

rotation applies only for public interest entities. Mandatory rotation of audit firms have not really been considered but only briefly discussed but denied almost instantly (US GAO, 2003).

2.3 Independence

An audit of a company follows a structured, documented audit plan in a systematic process and is conducted objectively. In order to conduct an audit objectively the auditors are independent, fair and do not allow prejudice or bias to override their objectivity (Hayes, Wallage & Görtemaker, 2014). The independency of the auditor is a fundamental principle of good practice and it makes the financial statements more credible (Eilifsen, Messier, Glover & Prawitt, 2013). The auditor obtains and evaluate evidence of economic actions and events and compares the evidence with the assertions by the management that are embodied in the financial statement. One assertion of management about economic actions could be that all the debts reported on the balance sheet actually exist at the balance date (Hayes et al., 2014).

Most of the regulators, accounting practitioners, and academics agree that auditor credibility is enhanced by auditor independence. However, there is no general agreement on how to define auditor independence among these parties (see e.g. Antle, 1984; Elliott & Jacobson, 1992). Auditor independence has been and is still a very discussed term. There is no single definition on auditor independence, however, according to Carrington (2010) the purpose of hiring an auditor is clearly to get an external independent view on the financial statements. If the auditor is not independent from his client, the whole concept of auditing would be meaningless.

As stated by Robert Mednick,

“independence is the cornerstone of the accounting profession and one of its most precious assets”
(Mednick, 1997, p. 10)

The auditors and audit firms use its independency as an asset together with its knowledge about accounting and audit techniques when they sell their services. At the same time there are much money to earn when doing services that are not directly related to audit services and the issue is to find a balance that is tolerated and not harming the independence. The audit firms are well aware of this dilemma and are following the changes of rules by the legislators. The legislators are involved in the issue of auditor independence and has imposed stricter regulation in order to protect the independence and confidence of the auditor after the financial crisis in 2008 (Carrington, 2010). According to DeAngelo (1981a) auditor independence is important because it has impact on the audit quality and is suggesting that audit quality is defined as the probability that the auditor will both disclose the breach by the audited company and that the auditor will report the breach. The audit quality will thus be impaired if the auditor does not remain independent and therefore not report the errors. Furthermore, DeAngelo (1981b) argues that an auditor's ability to retain the client in order to make up for the initial start up costs on the audit is directly related to the auditor's ability to maintain independence. This is most common when the auditor has underpriced the audit fee in order to acquire the client.

2.3.1 Independence in Fact and Independence in Appearance

Every auditor shall be independent and conduct an independent audit, but what does it actually mean for the auditor to be independent? According to Dopuch, King and Schwartz (2003) there are two aspects of auditor independence, independence in fact and independence in appearance. Independence in fact (real independence) is related to the auditor's ability to express an opinion about the financial statements without his or her professional judgement will be affected by factors which could negatively affect his or her integrity, objectivity or professional skepticism. The auditor with independence in fact would make the audit as correct as possible. The independence in appearance (perceived independence) is related to a third party. If the auditor is not perceived as independent by the users, the auditor is not seemingly independent (Dopuch et al., 2003). Together these two aspects of auditor independence are essential to achieve the goals of auditor independence. An auditor can be in fact independent without being perceived as independent. In addition an auditor can also be perceived as independent even though the auditor is in fact not independent. It is therefore important that the auditor not only acts independently, but also appears to be independent. In the best case scenario the auditor fulfills both aspects of independence (Cassel, 1996).

2.3.2 Possible Threats Against Auditor Independence

Auditor independence enhances the credibility of financial statement because of several reasons. If the auditor is independent the probability that the credibility of the financial statements will be increased and stakeholders are more likely to rely on the statements. If the independence of the auditor is diffuse or threatened it will have undesirable effects on capital markets. Thus understanding of possible threats against auditor independence is of importance (Dopuch et al., 2003).

According to Carrington (2010), the auditor has to be independent from his audit clients both in fact and appearance and to achieve this independence the Commission presented in 2002 a recommendation with possible threats against auditor independence and how to avoid them. The possible threats consist of self-interest, self-review, advocacy, familiarity or trust, and intimidation threats. Every auditor has to test its own independence against these possible threats. The test has to be done in the beginning of an audit engagement but it must also be continually updated during the engagement in the light of new information and tasks. The principal rule is that if an auditor's independence is questionable, the auditor must decline or resign from the engagement. However, if special circumstances exist or if the auditor has undertaken actions against the threats of independence, the auditor is allowed to accept or continue the engagement (Recommendation 2002/590/EC, 2002; Carrington, 2010).

In discussions about audit rotation a familiarity or trust threat occurs when the auditor has strong personal relation to anyone of its client, is too much influenced by the client's personality and qualities or has too long and too close relationship with the client. For example, if the auditor has been auditing the client for a long period there are possibilities that the auditor becomes too close to the client. An audit firm may have had a long association with the audit client, in sometimes more than 50 years of auditing (Hayes et al., 2014; Carrington, 2010).

The threats may fall into one or more of the possible threats of independence and if a threat is identified in an audit engagement, suitable safeguards should be applied in order to

reduce the threat of auditor independence to an acceptable level or to eliminate it. If the auditor is not able to eliminate or reduce the threat the audit should decline or resign the engagement. Safeguards could either be created by the profession, legislation, or by safeguards in the work environment. Different type of safeguards may include prohibitions, restrictions, procedures or disclosures and an example of a safeguard could be the rotation of an audit partner or other team personnel in the engagement that have audited the client for a long time (Hayes et al., 2014; Eilifsen et al., 2013).

2.3.3 Regulation on Independence in the EU and the US

Since the European Commission released its recommendation in 2002, the threats and safeguards have been applied in Member States' legislation. The Recommendation (2002) includes the rule of a seven year rotation on the lead audit partner. The new regulation in 2014 forces companies to rotate audit firms within ten years whilst the seven-year rotation on lead audit partner still applies (Regulation (EU) No 537/2014, 2014). In the Sarbanes-Oxley Act of 2002, in the US, the five possible threats are not mentioned, however, one chapter include nine sections of regulation on auditor independence. According to Section 203 the responsible audit partner of the client has to be rotated after five years (Sarbanes-Oxley Act, 2002). Moreover, the International Ethics Standards Board for Accountants provides a Code of Ethics for Professional Accountants which has found wide acceptance internationally. The Code of Ethics include the threats and safeguard approach under the name "The conceptual framework approach to independence". The EU recommendation in 2002 is based on this conceptual framework (Hayes et al., 2014; Eilifsen et al., 2013).

2.4 Audit Quality

The audit quality is a term that has been well-researched. However, there is no standard definition by researchers but some of the definitions are similar. As stated above in the section of auditor independence, DeAngelo (1981a) argues that audit quality is a function of the probability that the auditor will first disclose the breach by the audit company and then report the breach. According to Cameran and Pettinicchio (2011) the traditional definition shows that audit quality, auditor's competence and auditor's independence are linked:

"The traditional audit quality definition is ... the market-assessed joint probability that a given auditor both (1) detects irregularities (auditor competence) and (2) reports such an irregularity (auditor independence)" (Cameran & Pettinicchio, 2011, p. 86)

The auditors' competence is necessary to guarantee that the audit is professional. Consequently, there are specific requirements to become an auditor and further requirements to become a Certified Public Accountant (Cassel, 1996). According to a previous study made by Le Vourc'h and Morand (2011) there is unanimous agreement among stakeholders that there is a positive correlation between audit quality and independence of the auditor. The study concludes that auditor's independence in appearance is viewed, especially among investors, as a pre-requisite for audit quality. However, the term audit quality seems to have different meaning between various stakeholders. In another previous study, 70 percent of all investors expect that the audit will give a complete assurance that there is no errors in the financial statement (Wooten & Colson, 2003). On the other hand the auditors are well aware that this is not possible. An audit is able to obtain reasonable assurance

about whether the financial statements are free from material misstatement, however, this reasonable assurance is not an absolute level of assurance. This issue is often referred to as the audit expectation gap and results from the fact that users of financial statements have expectations about the auditors' duties that exceed the current practice (Hayes et al., 2014; Cassel, 1996). Power (2003) argues that several studies have indicated that the audit quality is difficult to observe because it is a function of how well the auditor is performing. Moreover, he points out that it is difficult to know what a "good audit" actually is and that the auditors themselves are not aware of if they are good auditors or not. In order for auditors to show external parties that they are good auditors they put much effort on work and work long hours (Power 2003).

2.5 Theories of Audit Services

2.5.1 Policeman Theory

The Policeman Theory was the most widely held theory on auditing until the 1940s. It is a theory based on public perception and suggests that the auditor's work is similar to a policeman's work, because the auditor focuses on preventing and detecting frauds (Hayes, Schilder, Dassen & Wallage, 1999). This way of thinking lead to an expectation gap regarding the work tasks of the auditor. However, in the 1940s the new line of thinking was that an auditor's job was to verify if the financial statements was disclosed in a true and fair way, which lead to a rejection of the policeman theory. However, recent accounting frauds, such as the Enron scandal, have resulted in careful reconsideration of this theory. Nowadays, it is debated what the auditor's responsibility is when it comes to accounting frauds, which yet again has lead back to the policeman theory because it is based on basic public perception and also a simple explanation of the demand for audit services (Hayes et al., 2014).

2.5.2 Lending Credibility Theory

According to Hayes et al. (2014), the Lending Credibility Theory is another theory based on public perception and is similar to the well-known Agency Theory. The Lending Credibility Theory states that the primary function of an audit is the increased credibility it provides to the financial statements. Management uses the audited financial statements to "enhance the stakeholder's faith in management stewardship." (Hayes et al., 2014, p. 44). The audit lends credibility to the financial statements and reduce information asymmetry. This give faith to the stakeholders that the information they receive is a fair representation of the economic value and performances of the company. It is the auditor's opinion that will enhance the degree of confidence and the aim of the auditor's opinion is to lend credibility to the financial statements (Hayes et al., 2014).

2.5.3 Theory of Inspired Confidence

The Theory of Inspired Confidence was developed by the Dutch Professor Theodore Limperg in the late 1920s. Unlike the preceding theories, this theory also consider the supply side of audit services, and not only the demand for audit services (Limperg Institute, 1985). According to Limperg, the outside stakeholders (third parties) demand management to be accountable in return for their contribution to the company. The participation of

third parties is the reason for demand for audit services. Limperg argues that the information given by management might be biased, because of conflict of interest between management and third parties, and therefore is an audit of the information required. Furthermore, the supply side of audit services is taken into consideration by Limperg's theory and it adopts a normative approach. The auditors should provide an audit that does not disappoint the expectations of a rational third party, but at the same time, the auditor should not provide greater expectations than the auditing justifies. According to the theory, the auditor should therefore do enough to meet reasonable public expectations (Limperg Institute, 1985).

3 Method

3.1 Choice of Subject and Perspective of the Study

This study has come into existence in the context as a Master Thesis in Business Administration. The topic of mandatory rotation of audit firms is interesting since it is a topic that has been discussed for a long time and because critical discussions and essential decisions have been made in the last five years. The topic is also very important to address since the EU and the US are trying to harmonize accounting rules to make it easier for investors around the world, but obviously decides to go separate ways when it comes to auditing regulations. Furthermore, we have not found any previous study that has compared viewpoints on mandatory rotation of audit firms from an investor's perspective. These factors are the reasons for the choice of subject to this study.

The mandatory rotation of audit firms is applicable on public interest entities, which mainly consists of publicly listed companies. It is of importance to highlight the role of the investors in these companies, because the characteristic of these companies is the fact that the ownership is often separated from the management. The investors must therefore rely on the information given in financial reports by the management and to their help they have the auditors, who increase the credibility of the reports (Hayes et al., 2014). Consequently, the investors' viewpoints of further regulation on auditors and audit firms should be carefully considered. Of course, the investors are not the only users of financial statements and not the only stakeholder to consider. However, the investors are often said to bear the largest risk since they get the residual return after all other stakeholders, such as the tax agencies, lenders and suppliers, have got their payment and return. In addition, in an investor's perspective, who invest in a global market, it is important that rules and regulations are harmonised around the world, which makes it interesting to study investors' viewpoints in the EU and the US regarding the regulation on mandatory rotation of audit firms.

Furthermore, the European commission stated in their Green Paper: "Robust audit is key to re-establishing trust and market confidence; it contributes to investor protection and reduces the cost of capital for companies." (European Commission, 2010, p. 3). The PCAOB further stated in their Concept Release: "The Board (PCAOB) is interested in commenters' views and data on those issues, including how cost and disruption could be contained, as well as on whether and how mandatory rotation would serve the Board's goals of protecting investors and enhancing audit quality." (PCAOB, 2011, p. 3). Their statements in the public consultations clearly shows that they want to protect the investors with their regulations, however, the legislators decided on two contradictory approaches.

3.2 Research Design

3.2.1 Research Approach

A research approach can be separated into three different types; inductive, deductive, and abductive approach (Bryman & Bell, 2007). This study has taken an abductive approach, which is a combination of inductive and deductive approach. A deductive approach implies that the researcher starts from already existing knowledge and theory within the subject to be able to either confirm or reject a theory after an empirical study has been done. In contrast, an inductive approach implies that the researcher based on his collected data create new theories and knowledge about the subject (Bryman & Bell, 2007).

In the beginning of this study, a brief observation of the replies was done to the Concept Release and the Green Paper, which shaped the purpose and the research questions. We continued by collecting information and background to the subject that shaped the introduction section. Further on, we gathered information about important concepts and existing appropriate theories regarding the subject, which is included in the frame of reference. Later on, data was collected from the replies to the concept release and the green paper that will result in new knowledge about the subject and indicates an inductive approach to the research. However, the data is also analysed by the concepts and theories in the frame of reference, which suggests a deductive approach. It would be more difficult to investigate the research questions if existing theories and important concepts were excluded.

3.2.2 Research Strategy

A research strategy is normally a quantitative or a qualitative research. In a quantitative research, data is collected and transformed into numbers and thus related to numerical interpretation, whereas a qualitative research is usually concerned with words rather than numbers (Bryman, 2012). In this study the qualitative research strategy will be used since the study concerns investors' arguments and viewpoints in text documents. The replies from the investors will be studied in-depth and analyzed in order to get more knowledge and give more detailed information. Furthermore, in a qualitative research, the researchers' interpretation and experience of the problem of the study plays a central role. This can be viewed as a disadvantage because it may make the study subjective but it also provides the study with higher flexibility than in a quantitative research (Bryman 2012). The qualitative approach suits this study better since we as researchers wish to understand and interpret the investors' arguments.

This study is based on secondary data such as scientific articles, books and official documents. The main attribute to this study consists of the documents from the EU and the PCAOB. The documents comprises of the replies to EU's and PCAOB's consultation - the Green Paper and the Concept Release.

The scientific articles that were used in this study were collected from databases such as Scopus, Bussines Source Premier and Science Direct. In the literature search, following key words have been used:

Mandatory rotation, partner rotation, firm rotation, auditor independence, audit firm tenure, audit partner tenure, audit quality, role of auditor.

The keywords have also been combined in order to specify the search to the chosen field. The scientific articles which are used in this study have before publishing been peer reviewed, which means that they have been reviewed by researchers in the same field, which increase the articles credibility. It has also been considered how often the scientific articles have been cited by other researchers.

3.2.2.1 Selection of Replies

The empirical findings of this study consists of replies to the European Commission's Green Paper and the PCAOB Concept Release. The total number of replies to the Green Paper was 688 and to the Concept Release 684. The study focused on the investors' viewpoints and therefore the investors' replies were collected as data. The European Commiss-

ion divided the replies to the Green Paper into seven groups: users (investors), academia, audit committees, audit profession, preparers (companies), public authorities, and others. We chose to follow the European Commission's classification of investors (users) when collecting data both from the replies to the Green Paper and the Concept Release. By following a large and well-known organizations classification gives legitimacy to the selection of replies, which is why this study follows the classification of the European Commission. The European Commission also mention that some organizations can be classified into two groups, however, their replies are only represented in one. Therefore, we also went through the group of preparers to include the replies from organizations that were seen as both investors and preparers. The PCAOB have not made any grouping of their replies, so we checked every reply and distinguished which replies were investors, according to the classification. The respondents consist mostly of institutional investors, such as pension funds, insurance companies, investment companies, and various associations that usually represent a larger group of investors.

Some of the investors' replies were excluded due to different reasons:

- Replies from Audit Committees, since they are treated as a separate group in the European Commission's classification.
- Replies that did not reflect the opinion of the whole organization. Personal opinions are categorized in another group than the group of users, according to the European Commission's classification.
- Replies in other languages than English.

After the selection of replies, the study consisted of 42 replies, 22 replies to the Green Paper and 20 to the Concept Release. These organizations are recognized in Appendix 1 – Respondents in the EU and Appendix 2 – Respondents in the US, which also shows if the organization supported or opposed regulations on mandatory rotation of audit firms. All of the replies are publicly available at the European Commission's webpage¹ and the PCAOB's webpage².

3.2.3 Design of Introduction

The introduction section starts with scandals and the concept of audit rotation to give the reader basic knowledge of the subject and also why and how audit rotation has been discussed and developed. Further on, the problem that the legislators in the EU and the US have chosen two contradictory approaches even though they wish to achieve the same thing is explained. Followed by the purpose and the research questions, which explain that the study wishes to enlighten and compare investors' viewpoints on mandatory rotation of audit firms and to find out if the investors' viewpoints have had any impact on the legislators' decisions.

¹ http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm - Go to *View the Contributions* by clicking on *Contributions authorised for publication*. (Accessed 2015-05-10)

² <http://pcaobus.org/Rules/Rulemaking/Pages/Docket037Comments.aspx> (Accessed 2015-05-10)

3.2.4 Design of Frame of Reference

The frame of reference consists of important concepts and appropriate theories regarding the subject. It begins with general arguments that either supports or opposes regulations on mandatory rotation of audit firms and international experience of the subject from countries that either have it regulated, have had it regulated or earlier have considered to adopt such regulations. The international experience section is included in the study to give an insight to why the countries earlier chose to have or not to have mandatory rotation of audit firms. It continues with two important concepts, auditor independence and audit quality. These are important since the EU and the US want them increased and also because they are the general arguments. Finally, the frame of reference includes three appropriate theories: the policeman theory, the lending credibility theory and the theory of inspired confidence. These are appropriate since they deal with the demand and supply of audit services, two of them (policeman and lending credibility) according to the public perception and one of them (inspired confidence) more researched and reported on.

3.2.5 Design of Empirical Findings

The public consultations included questions about mandatory rotation of audit firms where the European Commission and the PCAOB asked for general remarks, opinions, viewpoints, advantages, and disadvantages regarding the proposed regulations. However, the answers were not divided into separate answers to each question. Instead, the respondents had merged their replies into a flowing text or answered multiple questions together. Because of this, the empirical findings are not divided into questions and answers and neither divided each organization separately. Instead, we performed a content analysis that categorized the replies into five different sections and divided the sections in empirical findings accordingly. The four most developed sections were about: auditor independence, audit quality, current regulation, and audit committee. The auditor independence section includes answers that mentions auditor independence and objectivity in their reply. The audit quality section includes replies that mention concerns for audit quality such as audit risks, first years of engagements, lack of knowledge, lack of competence, fresh look, and audit costs. The current regulation section includes responses that argue that current regulation, such as audit partner rotation, is sufficient. The audit committee and transparency section includes answers that mention concerns towards audit committee and disclosure or transparency. Furthermore, the fifth and final section is called the other remarks section, which highlights arguments that were different from other and supported or suggested by only a few of the investors.

3.3 Quality Assessment

It is important to critically evaluate the research. This study considers two important aspect, the reliability and the validity.

3.3.1 Reliability

According to Bryman (2012) reliability is concerned with whether or not the collected data in the study is trustworthy and that the outcome of the study would be the same if it were undertaken yet again. There are two types of reliability in a qualitative research, internal re-

liability and external reliability. Internal reliability means whether or not the authors of the study agree about what they observe and conclude. External reliability means to which degree a study can be replicated (Bryman, 2012).

The objectivity of the authors were maintained throughout the research due to the low amount of pre-knowledge of the subject and the absence of preconceptions regarding regulations on mandatory rotation of audit firms. This means that the authors of the study could agree on what was observed, analysed and concluded and that the study is not reflected by the authors' own beliefs. Therefore, it implies that the outcome of the study should be the same if the study was undertaken yet again. However, the selection of replies resulted in a small amount of replies, which might differ depending on the definition of investors and the deselecting of some organizations. This might have an impact on the empirical findings but most likely no impact on the outcome of the study, due to the fact that it is a qualitative study with a main focus on words and the vast amount of opposing replies. Also, many of the replies represented numerous investors rather than a personal opinion.

3.3.2 Validity

Bryman (2012) argues that validity is concerned with the integrity of the conclusions that are generated from a piece of research. Validity refers to if the study researches what it is supposed to research. There are two types of validity in a qualitative research, internal validity and external validity. Internal validity means whether or not there is a good match between the study's empirical findings and its theoretical ideas. External validity means to which degree the empirical findings can be generalized (Bryman, 2012).

In this study, secondary data is used and the validity of secondary data is referred to how the data was collected and by whom it was collected. According to Bryman (2012) several factors should be taken into consideration if the study wants to achieve high validity, these factors are: reputation of source, accessibility, and method used to collect data. The data was collected from the PCAOB and the European Commission, which in turn collected it directly from the investors. The PCAOB and the European Commission are two large and well-known organizations and are seen as sources with high reputation and therefore equals high validity. The two public consultations along with the replies are publicly available on each organizations webpage, which means that it has a high accessibility and suggests high validity. A final factor that could increase or decrease validity is whether or not the collected data is suitable for the study, which it is in this case since the purpose of the study is to interpret replies from investors on regulation regarding mandatory rotation of audit firms. Those replies are gathered on the organizations webpages and the secondary data is therefore suitable for the study and highly valid. The external validity is relatively low, since the study does not intend to generalize all investors around the world. This study investigates the investors' replies to the Green Paper and Concept Release and their viewpoints are not necessarily shared by investors who did not submit a response to the public consultations.

4 Empirical Findings

4.1 EU Investors' Viewpoints on Mandatory Rotation of Audit Firms

The empirical findings to the Green Paper consists of 22 replies. The 22 respondents' names can be found in Appendix 1 – Respondents in the EU, along with the information if they supported or opposed the suggested regulation. Out of the 22 respondents, two of them supported regulations on mandatory rotation of audit firms. Of the 20 who opposed, 17 strictly opposed the idea, two opposed but added that if other options did not help then mandatory rotation could be a solution, and the last one supported fixed terms but did not support mandatory rotation.

4.1.1 Auditor Independence

Most of the respondents' replies highlight the importance of auditor independence. The Slovak Insurance Association state:

“The auditor’s independence is the key prerequisite for the entire concept of auditors as a public profession and we fully support any improvement in respect of control of such independence.”

According to Eumedion, the accounting scandals in the early 21st century and the latest financial crisis has resulted in a loss of investors' confidence in the independence of the auditor. Furthermore, Swedish Shareholders Association state that the independence of auditor is vital to the audit process. However, they argue that the reasoning behind the proposal of mandatory rotation of audit firms is difficult to understand because the Commission does not explain what the problem is with the current auditor independence. In addition, they point out that independence of the audit firms are already sufficient and well balanced with current regulation and standards, which emphasises relevant requirements on independence of audit firms. The Germans Insurance Association's arguments of auditor independence are similar. They argue that the recent financial crisis have not resulted in any new insights which would require changes with regards to auditor's independency. They do understand the concern that is raised by the Commission in the Green Paper about too long engagement between the audit firm and the audit client. However, they argue that the limitation should not be limited beyond what is already required today. Other aspects, such as cost of mandatory rotation and the possibility of reduction of the audit quality must be considered. They argue that to ensure auditor independence and keep up with high audit quality the current regulation with the requirements to rotate the key auditor partners in the audit firms is sufficient.

Blackrock Inc. neither believe that mandatory rotation of audit firms will improve auditor independence or the objectivity. Instead they argue that adequate safeguards can and should be established to review the auditors of public interest entities. Independent reviews, made by oversight boards, should determine and assess whether the auditors are independent and following relevant standards. In addition, Blackrock promote the existing regulations on rotation of audit partners to ensure that independence and objectivity is sufficient. According to CFA Institute there are two alternative options to support auditor's independence instead of mandatory rotation of audit firms. The two options provided are to increase audit standards and prohibit audit firms from selling non-audit services.

However, the Local Authority Pension Fund Forum that support mandatory rotation of audit firms argue that engagement between an audit firm and an audit client should not be longer than ten years in order to ensure auditor independence. They argue that best practice would be to rotate audit firm after five years. The Danish Shareholders Association who also support mandatory rotation of audit firms suggest five years as a maximum length of an audit engagement before rotation, however, they do not provide any further arguments about auditor independence. Instead, they mention the principal-agent conflict that the auditor is working closely with the board and management which the auditor is auditing.

4.1.2 Audit Quality

Many of the responses to the EU Green Paper regarded the matter that regulations on mandatory rotation of audit firms would change audit quality. Alliance Trust believe that mandatory audit firm rotation will increase audit costs, especially during the year when it is time to shift to a new auditor since the company has to invest in both management and auditor time. They also argue that it is better to let audit committees to assess auditor performance and audit tendering, if you want to improve audit quality and decrease audit costs. Further on, the CFA Institute believe that audit quality can be enhanced by higher auditing standards and that the costs of implementing regulations on mandatory audit firm rotation exceed the benefits. Furthermore, the Investment Management Association question how a high audit quality could be consistent worldwide if only the EU has mandatory audit firm rotation. They think it is difficult to manage a high audit quality on a global basis. According to Investment Management Association, this is extremely important since even more investors invest internationally and in international companies.

Eumedion argue that there is a risk that mandatory rotation of audit firms could decrease audit quality because of the new auditors lack of knowledge in the company's business and industry, especially in the first years after the rotation. They state that complex multinational companies require time and knowledge from the auditors, which is why mandatory rotation of audit firms is not their first recommendation. The Irish Funds Industry Association are concerned that mandatory rotation of audit firms would increase costs and potentially impact audit quality negatively. This since they believe that mandatory rotation of audit firms implies a higher audit risk in the first few years after a rotation. Further on, Ralipen Investment are also concerned that mandatory audit firm rotation would pose a significant risk to audit quality since there is a higher risk of audit failure in the first years of a new audit engagement. The Swedish Shareholders Association say that mandatory rotation of audit firms would impose unacceptable high audit costs and that it would lead to a decrease in audit quality.

The Deutsches Aktieninstitut believe that mandatory rotation of audit firms would decrease audit quality because of the lack of in-depth knowledge in the company's business and industry, which is gained by an audit firm that has a long relationship with its client. This in-depth knowledge leads to that the audit risk decreases and less audit errors are made. The German Insurance Association think that regulations on mandatory rotation of audit firms cannot maintain a high audit quality since there would be increasing costs due to initial training period in the new engagement and the loss of knowledge from the previous engagement. The increased costs and loss of knowledge leads to a decrease in audit quality and audit efficiency.

The British Venture Capital Association think that mandatory rotation of audit firms would increase audit costs, which would backfire on the investors. They also suggest that audit quality instead could be enhanced by a wider adoption of the current best practice instead of new or additional regulation. The National Association of Pension Funds believe that mandatory rotation of audit firms and any other limits to the audit engagement would be harmful for the company and the audit quality. The Slovak Insurance Association also do not support mandatory rotation of audit firms and mentions that such regulations was abolished in Slovakia in 1999 since they did not have any positive impact on overall audit quality.

Standard Life Investment argue that any limitation regarding audit engagement time may result in lower audit quality. The reason for this statement is because of the new auditors' lack of knowledge in the company's business and industry and also because of the high audit risk in the early years of a new audit engagement. Standard Life Investment suggest that the European Commission should encourage the audit regulators in each member state to research if long audit engagement decreases audit quality. If this further research shows that it decreases audit quality, there is a reason to discuss legislating mandatory rotation of audit firms. In addition, they believe that the mandatory rotation could lead to that audit firms avoid difficult audit decisions since they know that it could be passed over to the next auditors and this action would be a systemic reduction in audit quality.

Aviva say that mandatory rotation of audit firms might create significantly low quality audits for the first two years in an audit engagement, due to the fact that the audit firm goes through a learning curve because of lack of knowledge and competence within the company's industry. Audit quality could also decrease because of the fact that the best quality audit staffs rotates to an on-going audit relationship instead of remaining with a company for the last two years of an engagement. According to Aviva, these two together would give four years of potentially lower quality audits. Blackrock Inc believes that large companies require continuity of the audit relationship so that they know that the audit firm will devote adequate resources so that the audit staff can gain knowledge and competence of the company's business and industry in order to decrease audit risk and enhance audit quality. Also, the continuity would avoid audit costs that occur when entering new engagements.

4.1.3 Current Regulation Sufficient

Eumedion, who oppose mandatory rotation of audit firms, support the current legislation of audit partner rotation within the same audit firm. However, they argue that the partner rotation must be visible to the outside world and not only appear to be a formality. According to Eumedion, more research is needed to testify if it is reality that the partner rotation is not only a formality. If the research shows that partner rotation is not effective, Eumedion argue that the mandatory rotation of audit firm should be considered. In addition, Irish Funds Industry Association argue that the present rules and regulation for auditor independence is sufficient and if the legislators try to further increase rules and regulation on auditor independence it would lead to reduced choice over selection of service providers.

Two of the respondents, Deutsches Aktieninstitut and German Insurance Association, mention the Directive 2006/43/EC on Statutory Audits adopted in 2006 and argue that this Directive addresses many of the problem about auditor independence that are discussed in the Green Paper. Deutsches Aktieninstitut further argue that the Directive 2006/43/EC, which states that audit partners must rotate from the audit engagement after

seven years, is necessary and sufficient for auditor independence. They propose an in-depth evaluation of the Directive 2006/43/EC before the legislators take any new regulatory action. According to the German Insurance Association, regulation on mandatory rotation of audit firm would be a risk of excessive regulation and unnecessary bureaucracy which would not automatically lead to the intended purpose. The current regulation on rotation of audit partners in EU is sufficient to ensure auditor independence and a high level of audit quality. Furthermore, they argue that it must be ensured to a greater extent that there are compliance with the requirements in the Directive 2006/43/EC before new regulations are implemented.

Swedish Shareholders Association argue that the current regulation is well balanced concerning the rotation of audit partner rotation, which meet all relevant requirements on independence of auditors and their audit firms. Further regulation on rotation of audit firms would only add new costs to the companies, which in turn would diminish the return for the investors. The British Venture Capital Association's arguments are similar to Swedish Shareholders Association and additionally they argue that instead of require new regulation, audit quality should be enhanced by a wider adoption of current best practice. Ralipen Investments explain that according to the UK APB Ethical Standard 3.7, there is a maximum time period of five years for the audit partner rotation. However, the audit committee can approve the audit partner to continue as the auditor of the company up to a two years extension. They support the mandatory rotation of audit partner rotation up to five years and consider that the extension should be seen as an exception rather than the rule and that the extension must be justified by the audit committee in its annual report.

4.1.4 Audit Committee and Transparency

International Corporate Governance Network argue that the regulation of mandatory rotation of audit firms will be unnecessary if an audit committee, consisting of independent non-executive directors, decides on the appointment of the auditors and the investors are more involved in the process, together with more transparency. In addition, Alliance Trust argue that instead of regulation on mandatory rotation of audit firms, the audit committee would assess and review the auditor's performance to improve audit quality and to decrease cost. Association of British Insurers further argue that it is important that the audit committee has a properly considered programme where they evaluate and review the auditor's performance. This programme should be disclosed to shareholders and the audit committee should also disclose what their policy is and why they have adopted it. This could in turn qualify the company to reappoint the same audit firm.

Investment Management Association point out that the lack of transparency and argues that companies must improve their transparency on processes for auditor selection, which would enhance the investors' engagement in discussions with the audit committee and board of directors. Investment Management Association argue that a company should be transparent on how they decided the appointment, reappointment and removal of auditors. Furthermore, they should disclose information on when the audit was up for tender last time, when the current auditor was selected, and if there are any contractual obligations that restricted the audit committee in the selection of auditors. If it is necessary the companies should also explain to major investors about any changes of auditors. According to Investment Management Association, improved discussions between audit committees and the investors would help investors to understand the auditor-client relationship and will further enable shareholders to be more involved in the selection process of auditors.

Aviva's reply also points out the need of better disclosure but that the audit committees should consider the engagement of the auditor annually. CalPERS argue that the audit committees should promote rotation of the auditor to ensure a fresh perspective and review the financial reporting framework and that the audit committees should explain how the auditors independence is safeguarded. Furthermore, the CFA Institute connects the audit committee with auditor's independence and argues that the auditor's objectivity would be stronger if the auditor had a better and closer reporting relationship with its client's audit committee. They further emphasise that the audit committee should have a much greater role and increase its time commitment.

Ralipen Investments agree with the European Commission that an excessively long engagement between the audit firm and audit client is not in the interest of investors or not even in the public interest. However, they still oppose the mandatory rotation of audit firms since the company might be forced to change audit firm at a troublesome time and the audit committee has more knowledge to judge when it is the best time to change audit firm. In addition, they call for more transparency from audit committees. They argue that a comply or explain regime will lead to changes in the rotation of audit firm when shareholders will notice that the company has had the same audit firm for a long time. This in turn will encourage companies and their audit committees to consider the concern of the investors.

4.1.5 Other Remarks

The Association of British Insurers believe that mandatory rotation of audit firms could worsen competition and choice, if there is already a limited choice of firms to engage. However, they still do not support mandatory rotation of audit firms since the drawbacks exceed the benefits. The Association of Pension Funds Management Companies mention that mandatory rotation of audit firms was once required by legislation in Slovakia but that it was removed since it did not show any advantage. The CFA Institute suggest that independence could be increased by other means than legislating mandatory rotation of audit firms. For example by focusing on rising auditing standards and prohibit cross-sale of non-audit business. Investment Management Association believe that mandatory rotation of audit firms could result in a forced change of audit firms in a time where the existing auditor's familiarity, knowledge, and competence in the company's business is crucial. For example in situations when there is a major acquisition or merger in place.

Hermes Equity Ownership Services believe that auditors stay in engagements for too long and that more frequent tender processes would enhance the competitiveness of the auditing market. Therefore, they propose that auditors should be given a fixed length of engagement and that the auditor cannot be removed from the company during that period. This would strengthen the relationship between the auditor and the company and thereby enhance audit quality. They continue by saying that it would mean that the shareholders only were able to appoint auditors on, for example, a six year cycle but that it would be an acceptable price to pay for the possible benefits to audit quality and competition. They also add that it is possible to reappoint its prior auditor.

4.2 US Investors' Viewpoints on Mandatory Rotation of Audit Firms

The empirical findings to the Concept Release consist of 20 replies. The respondents' names can be found in Appendix 2 – Respondents in the US. All of the 20 respondents strictly opposed regulations on mandatory rotation of audit firms.

4.2.1 Auditor Independence

The British Columbia Investment Management Corporation argue that the auditor independence is essential to the efficient functioning of capital markets and that reinforcing independence is a good initiative by the legislators. However, they argue that the proposal of mandatory rotation of audit firm will not significantly improve auditor independence. Further they argue that it is the audit committee and the board of directors that should ensure that auditors are independent and that mandatory rotation of audit firm could impair this function. They recommend the PCAOB to give the current standards more time to take effect and then reassess the independence of the auditor in a couple of years.

New York Life Insurance Company argue that the objective of ensuring auditor independence is not reached by mandatory rotation of audit firms and point out the advantage of the long-standing relationship they have had with their current auditors which has served them and their policyholders extremely well over the years. They discuss that a long relationship with an audit firm is not necessarily reducing auditor independence. Instead, the long relationship provides the audit firm with deep knowledge and insight into the companies business activities and financial process. Furthermore, they argue that the audit committee is best suited to evaluate whether auditors are independent, rather than the legislators. Pacific Life Insurance Company provide similar arguments as New York Life Insurance Company about auditor independence and emphasizes the importance of the argument that audit committee is in the best position to determine whether the auditors are independent or not, and it should be the responsibility of the audit committee to ensure the independence of the auditors. State Street Corporation share this viewpoint and further argue that the auditors are forced to be compliant with the AICPA code of conduct, which states that the auditors must maintain its independence and objectivity during the engagement, and therefore it is not needed further regulation on auditor independence in form of mandatory rotation of audit firms.

According to the Flaherty & Crumrine Funds, auditor independence has improved substantially and oppose the proposal of mandatory rotation of audit firms as a tool to improve auditor independence. Unum Group understand that the proposal of mandatory rotation of audit firm is intended to enhance auditor independence, however, they believe that a forced rotation will not result in more independent or objective auditors. Instead, Unum Group believe that the best method to increase auditor independence is to continue with the current inspection program by the Public Company Accounting Oversight Board and the rotation of audit partner.

Federated Investors argue that it is not possible to conclude that mandatory rotation of audit firm will enhance auditor independence without fully investigating if auditor independence diminishes as the audit tenure increases and if it is the low auditor independence that has caused the observed audit failures. They believe that the argument that a long relationship between the audit firm and client would lead to diminished auditor independence is

unsupported. In addition, MFS Investment Management believe that mandatory rotation of audit firms would not increase auditor independence and point out the argument that they do not perceive auditor independence to be lacking and further believe that there are functions already in place to guaranty the independence of the auditors. Furthermore, Black-Rock point out that they are not aware of any empirical evidence proving that mandatory rotation of audit firms would improve auditor independence and therefore oppose the proposal of mandatory rotation of audit firms. They believe that further steps need to be taken before considering the mandatory rotation and that more research on the subject is needed. In addition, they recommend that the auditors should be required to have annual trainings on auditor independence, as an alternative solution to improve auditor independence. Investment Company Institute argue that if it is needed to further enhance auditor independence, it should be increased by standard settings, inspection, and enforcement programs, rather than through requiring mandatory rotation of audit firms.

4.2.2 Audit Quality

New York Life Insurance Company think that the long-term relationship they have with their audit firm have resulted in a greater knowledge and competence of the auditor, which in turn has satisfied the company and the shareholders with high quality audits. They also believe that a mandatory rotation of audit firms would increase audit risk and audit failure until the new firm has developed enough knowledge of the company's business. Further they argue that this cost of decreased audit quality far outweighs the potential benefits of a mandatory rotation of audit firms. Pacific Life Insurance Company also value their long-time relation with their audit firm because the audit firm now has an in-depth knowledge of the company's business, processes, and management. They argue that an audit partner rotation gives a new perspective and at the same time maintain a high audit quality while an audit firm rotation would increase risk of audit failure and decrease audit quality. The length of time required by the new audit firm to gain knowledge about the company's operations, business, and management would result in a reduction in efficiency and effectiveness and in turn a decrease in audit quality. Meadowbrook Insurance also believe that mandatory rotation of audit firms could reduce both efficiency and effectiveness of an audit due to the new audit firm's learning curve in the beginning of every new engagement.

State Street Corporation and Fidelity Investments aruge that there is a lack of evidence of correlation between audit failures and audit firm tenure. Instead, they believe that audit firm rotation will increase cost, time, and effort of the company to give the new audit firm enough expertise and knowledge to perform an audit, and this learning process would reduce efficiency and decrease audit quality. The Hartford Financial Services Group also believe that mandatory rotation of audit firms would result in increased costs due to the learning curve the new audit firm faces. In addition, they argue that this is especially a problem if the company faces some changes at the same time as it has to switch audit firm and then needs to teach the new audit firm everything before the change and everything after the change instead of just focusing on the change and what happens after. In their opinion the mandatory rotation of audit firms could result in a decrease in audit quality, especially in the first few years of a new audit engagement due to the lack of knowledge.

British Columbia Investment Management Corporation further argue that previous studies show that the number of audit failures is greater in the first years of a new audit engagement because of the new auditors do not have enough knowledge. Mandatory rotation of audit firms would result in more new engagement on a regular basis, and it would imply

that there would be more audit failures. Assured Guaranty and Investment Company Institute also believe that mandatory audit firm rotation could increase audit failure in the last years of an engagement since the audit firm may be tempted to move their best auditors to new engagement where the auditors would have greater development opportunities. Therefore, they argue that mandatory rotation of audit firms could result in low quality audits in the first few years and the final years of an engagement, which according to them is not an appreciable result. American Council of Life Insurers feel that the PCAOB has failed to present evidence that shorter audit tenures would result in higher-quality audits. Instead, they also believe that mandatory audit firm rotation would decrease audit quality because of the new audit firm's lack of knowledge and experience in comparison to the former audit firm. The cost, time, and effort the company has to put into the learning process of the new audit firm are consequences of mandatory audit firm rotation that does not exceed the benefits of it. Moreover, Aflac refer to previous studies when they argue that audit quality will have to be sacrificed due to the learning process of the new audit firm since the risk of audit failure is particularly higher in the first two years of a new audit engagement. They believe that audit costs would increase since audit firms has to spend more resources on learning the new company's business and that this additional cost will eventually be passed on to the clients in the form of audit fees.

Assurant think that a long-time relationship to the audit firm is necessary to ensure a high audit quality and that mandatory audit firm rotation would jeopardize the audit quality because the new audit firm might not have enough knowledge of the company's business, operations, and processes. Also, it would mean that the company has to spend time, money, and effort to educate the new audit firm at every mandatory rotation. The time would be better to spend on enhancing strong internal controls and processes. In addition, Allied World Assurance Company argue that mandatory rotation of audit firm will decrease audit quality due to the time, effort, and costs of educating the new audit team, especially in large and complex international organizations. Assured Guaranty believe that mandatory rotation of audit firms would decrease audit quality because of inadequate knowledge of the new audit team. They further believe that specific knowledge of a company's business, industry, and procedures are important to ensure a high audit quality, which is learnt by long-term audit engagements. They also add that the time audit firms have to spend on obtaining new clients, if mandatory rotation was implemented, would be better to spend on servicing existing clients.

Federated Investors, MFS Investment Management and Capital Research and Management Company believe that mandatory audit firm rotation will decrease audit quality due to the learning curve new audit teams face when entering new engagements. The insufficient knowledge of new audit firms increases risk of audit failures and forced rotation could lead to audit being performed by less qualified audit firms. In addition, Capital Research and Management Company argue that the lack of knowledge must be solved by education from the companies. Blackrock Inc. believe that mandatory rotation of audit firms would decrease audit quality, especially on multinational companies, due to the learning curve for new audit teams. They argue that mandatory audit firm rotation might also reduce audit quality because of the lack of incentive for audit firms to make long-term investments and relocate professional expertise to support a multinational client. Blackstone Group believe that audit teams with great experience and knowledge of the company's business and industry perform high quality audits. This is not achieved by mandatory rotation of audit firms since forced rotation could mean that the company has to select an audit firm with less or no knowledge in neither the business nor the industry. According to Blackstone Group,

this risk of lower quality audits outweighs the potential benefits from mandatory audit firm rotation.

4.2.3 Current Regulation Sufficient

Pacific Life Insurance Company argue that the current rigorous PCAOB inspections is sufficient and provide strong governance over audit firms to perform quality in their audits. Furthermore, they argue that the current system of mandatory partner rotation is enough to reinforce the auditor independence and objectivity. State Street Corporation believe that the existing standards and regulations are sufficient and mention rules such as the current partner rotation every five years, the responsibility of the audit committees, and PCAOB's review of audit firms. According to The Hartford Financial Services Group, the objectives of mandatory rotation of audit firms is already achieved by the current partner rotation and therefore mandatory rotation of audit firms is not needed. They argue that the partner rotation may not provide as "fresh look" as the rotation of an audit firm, however, it offers a new look to the financial statement without all disruption and knowledge loss that a rotation of audit firm would lead to.

Flaherty & Crumrine Funds further argue that the current rotation of audit partner is too short and should be extended by a couple of years. The process of rotating auditor is time-consuming and the learning curve for the new auditor provides the audit with higher risks. Flaherty & Crumrine Funds state that the Sarbanes-Oxley Act of 2002 was a giant step in the right direction to enhance the client-auditor relationship. Unum Group further argue that the safeguards to enforce auditor independence and quality in Sarbanes-Oxley Act is sufficient and the current rules, which are governing the client-auditor relationship, are already considering the risks that the proposed mandatory rotation of audit firms would cover. Assurant, has the same viewpoint and further adds that the current regulation implemented by the Sarbanes-Oxley Act provides strong protection of auditors' independence and quality of the audits. British Columbia Investment Management Corporation claim that there is a general consensus that rules implemented by the Sarbanes-Oxley Act have had a positive effect on the quality of audits of public companies. Fidelity Investment argue that one of the major reforms of Sarbanes-Oxley Act was to strengthen the role of a the audit committee, which has become an important "watchdog" over the auditors.

4.2.4 Audit Committee and Transparency

According to both the New York Life Insurance Company and Assurant it is of importance that the audit committees continue to have the autonomy to choose the best auditor, based on the audit firm's experience and industry knowledge. However, if companies would be forced to rotate audit firms it could lead to selection of a less qualified audit firm and audit committees would then not be able to choose the best audit firm for the company and other stakeholders. Moreover, Assurant point out that there are no evidence which shows that audit committees are failing to appoint and monitor the auditors and audit firm. Flaherty & Crumrine Funds state that the audit committees have been given the responsibility to choose auditors, set compensation for their services, and review the quality of services provided. The decision to maintain an audit firm should be dependent on the firm's performance, however, if companies would be forced to rotate audit firm the audit committees would lose the full control of selecting auditors.

State Street Corporation argue that if the proposal of mandatory rotation of audit firms would enter into force, it would prevent the audit committee's oversight role of the auditor and audit firm. In addition, British Columbia Investment Management Corporation argue that mandatory rotation of audit firms could undermine corporate governance by reducing audit committees' statutory responsibility for overseeing the audit function. The Unum Group present audit committee's role as representatives of shareholders' interests, and with responsibility to oversight the audit they are best suited to appoint and retain the audit firm they believe best meet shareholders' needs. If shareholders do not approve the selected audit firm at the annual general meeting, the audit committee will reconsider the decision of the audit firm and likely choose another one. Unum Group argue that a mandatory rotation of audit firms is unnecessary because there exists strong audit committees and shareholder ratification. If the audit firm is detrimental to the shareholders of the company, the audit firm would be rotated regardless any regulation on rotation. Further they discuss that the audit committee members and company management are exposed to sanctions if there are any audit and financial reporting failures, which give them an interest to ensure that the audit firms perform the audit with quality and that risks are being addressed.

The Hartford Financial Services Group further advocate the role of the audit committees and mention that audit committees establish policies requiring pre-approval of audit and non-audit services provided by the audit firm. During the pre-approval process the audit committees consider whether services are consistent with current rules on auditor independence. Allied World Assurance Company say that the audit committees work closely with the audit firms and if the committees believe that the audit firms lack knowledge and experience they would dismiss the audit firm and change to another firm. However, they argue that the mandatory rotation of audit firms would limit the audit committees to carry out their duty, which will hinder good corporate governance that they believe is important for the public interest. American Council of Life Insurers further argue that the audit committee's role to review the auditor mitigate potential issues regarding the relationship between the management of the company and the auditor. It keeps the relationship fresh and they argue that the audit committee's role is much more effective than a requirement for mandatory rotation of audit firms. Aflac take it further and argue that mandatory rotation of audit firms would undermine the authority of audit committees and places shareholders at risk and this would in turn violate the objective to protect investors.

According to MFS Investment, the audit committees are effective, however, they argue that not all audit committees are equal and there is always some committees that could be improved. Instead of regulating mandatory rotation of audit firms they argue that it is better to require at least one "audit expert" in the audit committee with in-depth knowledge of the audit process, which would provide the audit committee with an additional perspective on the audit. BlackRock further insist that there should be more guidance on how the audit committee could meet the responsibilities of ensuring audit independence, overseeing audit services, and determining the compensation of the auditor.

4.2.5 Other Remarks

The Hartford Financial Services Group question the potentially decreasing operability of regulations on mandatory rotation of audit firms. They argue that big multinational companies requires an audit firm with specialized knowledge in both the US and globally. They believe that these regulations can diminish the freedom of choice since there already is a limited number of audit firms that are capable of providing the appropriate level of service.

Mandatory rotation of audit firms could also affect a company's ability to adopt complex accounting standards and make it more difficult to undertake potential mergers or acquisitions while maintaining the current financial reporting. Flaherty & Crumrine Funds and Investment Company Institute suggest that the PCAOB should disclose more information in their inspection reports. This since they believe that companies would not want to switch audit firms if the company did not experience any issues with its own audits. However, if the PCAOB would reveal that the same audit firm have had audit issues related to another similar company, the first company might want to switch audit firm.

American Council of Life Insurers believe that mandatory rotation of audit firms could be specifically harmful for companies in smaller market since they require audit firms with specialized industry knowledge. This means that the company may have to hire an audit firm from another city and therefore increase audit costs due to travel expenses and also decrease audit efficiency due to the lack of local presence. Aflac believe that audit failures should continue to be dealt with on individual basis instead of having regulations on mandatory rotation of audit firms, which would burden all audit firms and all public companies instead of only the companies with audit failure. Aflac also believe that mandatory rotation of audit firms will have negative effects on the accounting profession since it would be more difficult for auditors to gain in depth knowledge in a company or an industry, which is a big reason to why one wants to work as an auditor. According to Aflac, potential accountants might change to corporate accounting instead of the audit industry, which would negatively affect the accounting profession.

5 Analysis

5.1 Differences and Similarities in Viewpoints

The investors in both the EU and the US acknowledge the importance of auditor independence in order to restore their confidence in the capital market. However, the majority of the investors in this study oppose the proposal of mandatory rotation of audit firms to improve auditor independence. Investors in both the EU and the US are providing the argument, against mandatory rotation of audit firms, that the current regulation for auditor independence and possible threat of auditor independence is sufficient. Both argue that further rules and regulations in form of forcing the companies to switch audit firms might lead to excessive regulation and not enhance auditor independence as intended by the legislators. Instead, they argue that it would lead to less alternatives for the companies to choose among potential audit firms.

The regulation of the audit market is different in the EU compared to the US. For the US investors it is the Sarbanes-Oxley Act of 2002 which is argued to be an important regulation for auditor independence whereas investors in the EU discuss the role of the Directive 2006/43/EC. US investors mention the Sarbanes-Oxley Act and the creation of PCAOB in the US as an effort to enhance auditor independence. One of the reforms of the Sarbanes-Oxley Act was to strengthen the role of audit committees and US investors argue that strengthen audit committees' role is much more effective than forcing a rotation of audit firms. Strengthen the role of the audit committee is also argued by EU investors to be a better alternative, and introducing the mandatory rotation of audit firms would instead limit the role of the audit committee, which is not supported. EU investors highlight the importance of transparency, which is not specified by investors in the United States. Investors in the EU argue that there is a lack of transparency on the process of auditor selection and more transparency would lead to more dedicated discussions about the selection of auditors and audit firms with both the audit committees and board of directors.

Investors in both the EU and the US highlight the importance of the auditors' knowledge and competence. However, they do it in two different ways. EU investors argue that the new audit firm, after a rotation, lacks the knowledge and the competence to complete the audit, while the US investors think that a good long-term relationship between the company and the audit firm gives the audit firm enhanced expertise and knowledge about the company's business and industry. Further on, investors in both the EU and the US believe that mandatory rotation of audit firms would decrease audit quality, especially in the first and last years of an audit engagement. In the first years due to the steep learning curve of the new audit firm and the time, effort, and resources that both the company and the audit firm has to spend to educate the new auditors. In the last years because the audit firms probably want to move their best audit staff to new and on-going audit engagements, instead of those who are about to end. Both EU investors and US investors believe that the time, effort, and resources they have to spend on educating the new auditors will affect the efficiency and effectiveness of the audit that they are about to do, which in turn will decrease audit quality and increase audit costs. Furthermore, the US investors also highlight the importance of having a long relationship between the company and the audit firm, especially if it is an international or a global company. An international or a global company requires a global audit firm with certain expertise in the company's line of business. If implementing mandatory rotation of audit firms, the company would have to find another similar audit firm. The costs of finding a new audit firm for such a company's demands are high.

The US legislators have decided not to force rotation of audit firms and instead continue with the voluntary and so-called natural rotation of audit firms. The arguments in this study by the investors in the US confirm that this decision is supported by the investors, since all of the investors in the Concept Release opposed the proposal of a regulation. However, the EU legislators' decision to adopt the regulation is not seen to be supported by the investors in the study. Legislators in both the EU and the US have the objective to enhance auditor independence and increase audit quality, however, they legislators use two contradictory approaches. It is difficult to predict the effect of the decision made by EU legislators and there are several supportive arguments for the decision as there are unsupportive arguments, according to earlier studies. However, the investors' mostly unsupportive arguments in this study makes the decision made by EU legislators questionable.

5.2 Lack of Evidence

Another similarity between the viewpoints of the EU investors and the US investor are that they both think that there is a lack of evidence due to the insufficient number of researches made regarding mandatory rotation of audit firms. There is a lack of evidence that poor audit quality or audit failure is linked to audit tenure or long audit engagements and there is a lack of evidence that long audit engagements decreases auditor independence. The EU investors find it strange that the EU would adopt regulations on mandatory rotation of audit firms without such evidence and the lack of evidence is one of the reasons that lead to a bill of prohibition of such regulations in the US. In the same way as there is a lack of evidence that long audit engagements decrease audit quality and auditor independence, there is also no evidence that short audit engagements would result in higher-quality audits or enhanced auditor independence. The lack of evidence leads to that the investors believe that mandatory rotation of audit firms will increase costs, time, resources, and effort for both the company and the audit firm due to the steep learning curve of the new auditors. Also, that the lack of knowledge and expertise in the company's business and operations would decrease efficiency and effectiveness in the audit process and in turn audit quality.

Moreover, the mandatory rotation of audit firms leads to less responsibilities and increased limitations to the audit committee. Some investors point out that there are no evidence which shows that audit committees are failing to appoint auditors, to monitor the audit process, or in any of their other responsibilities. Therefore, it is in the interest of the investors that the decision to maintain an audit firm or not should be dependent on the performance of the audit firm, which is controlled by the audit committee through their oversight authority.

5.3 Previous Studies

Even though the investors believe that there is a lack of evidence and not enough earlier studies, there are some studies that have been made regarding the subject of mandatory rotation of audit firms. The subject can be twisted to make it either positive or negative and as mentioned in the frame of reference, there are often two standpoints in the subject and two sides of every argument. However, only few investors supported regulations on mandatory rotation of audit firms and those who did were not so descriptive about their arguments, which means that there are no links to the general arguments from earlier research on mandatory rotation of audit firms. However, those investors who oppose mandatory ro-

tation of audit firms can be compared to the general arguments against such regulations. For instance, many of the investors brought up the argument that the new auditor's lack of knowledge about the company's business and operations would increase the risk of audit failure. Also, that the increased costs of implementing such regulations would exceed the benefits of it, mostly since the current regulation is sufficient when it comes to auditor independence. Furthermore, even though many investors believe that there is a lack of evidence that mandatory rotation of audit firms would either enhance or worsen auditor independence and/or audit quality, there are previous studies about international experience that suggests the negative. As we can understand from the US GAO study from 2003, legislators in Italy have noticed some audit fee pressures that might lead to a decrease in audit quality, in Singapore they believe that mandatory rotation is only necessary for banks, Spain abandoned mandatory rotation since they did not find it necessary, and Canada abandoned mandatory rotation because the costs exceeded the benefits. Austria, United Kingdom, France, the Netherlands, Japan, and Germany have earlier considered or discussed regulations on mandatory rotation of audit firms, but it was rejected due to the facts that costs exceeded benefits, audit quality would decrease, audit effectiveness would be reduced, and that auditor independence is equally achieved by audit partner rotation. All of the six latest mentioned countries have regulations on audit partner rotation.

5.4 Auditor Independence in Appearance and in Fact

It is difficult to measure the level of independence of the auditor, however, the two dimension of auditor independence, independence in fact and independence in appearance, mentioned in the frame of reference are applicable on the result of the study. Independence in fact indicates that the auditor possess an audit with an independent mindset while independence in appearance indicate whether the auditor appears to be independent (Dopuch et al., 2003). Most of the investors, from both the EU and the US, opposed the mandatory rotation of audit firms and argued that the current independence rules are sufficient. When the consultations were made there were already requirements of rotating the lead audit partner, maximum period of 5 years in the US and 7 years in EU, and most investors argued that the auditors already appears to be independent. However, since the legislators in the EU and the US have brought up mandatory rotation of audit firms as a proposal to enhance auditor independence, it could be an explanation that they believe the independence in appearance is not sufficient for external parties. According to Arel et al. (2005), studies on mandatory rotation of audit firms have shown that the rotation rule can lead to auditor's independence would be perceived as stronger by external parties. Mandatory rotation of audit firms could make the independence more apparent to stakeholders, however, it is more difficult to measure how it will affect the independence in fact (real independence). Investors do not argue that the rotation of audit firms will further improve the independence, instead they mostly argue that the current regulations provide sufficiently independent auditors. In the case of mandatory rotation of audit firm, it is questionable whether it is only the independence in appearance that will be improved while the independence in fact will not or if both of the dimension of independence would be improved or remain constant. A great majority of the investors in the study, both from the EU and the US, believe that the current independence of the auditors is sufficient, which lead to that real independence would not probably be improved according to their viewpoint. However, according to the supportive argument for mandatory rotation of audit firms provided by Arel et al. (2005), the independence in appearance would have a positive effect for external parties, which in turn could increase the audit quality. Eumedion, one of the inve-

stors who opposed mandatory rotation of audit firms, argued that the current audit partner rotation must appear to be effective for the stakeholders and not only be a formality. It shows that independence of appearance is of importance, however, rotation of audit firms is not necessarily needed to improve the independence of appearance.

A long relationship between audit firms and its clients could be seen as a possible threat against auditor's independence because the firms might be too dependent by a client and rather satisfies the client than criticize them in order to not risk of losing them as client. However, since most of the respondents in this study argue that current regulations on independence are sufficient, it appears to as they believe that there are enough safeguards in place to ensure the auditor independence. As Unum Group argued, the current safeguards to enforce auditor independence and quality is already sufficient.

5.5 Audit Quality

Many of the investors were concerned about the lack of knowledge and competence and also the decrease in audit efficiency and effectiveness of the new audit firm, if implementing mandatory rotation of audit firms. This would mean that the auditor would have a harder time trying to prevent and detect frauds, which means that the auditor may not fulfil his or hers responsibilities of acting as a policeman, according to the Policeman Theory. The failure of complying with this public perception would lead to that the public loses trust in the auditors and their profession. Further on, the same concerns about the new audit firm's lack of knowledge and competence and decreased efficiency and effectiveness would mean that the auditor cannot provide increased credibility to the financial statements, which is the goal of the Lending Credibility Theory. Since management uses the financial statements to enhance stakeholders' faith in the managers, the lack of credibility would mean that the stakeholders would lose faith in management. According to the Lending Credibility Theory, this implies an increase in information asymmetry and might lead to poor relationship between the management and the stakeholders. Moreover, the Theory of Inspired Confidence by Limperg would explain that the lack of knowledge and competence along with the decrease in audit efficiency and effectiveness would lead to that the new audit firm cannot reach the reasonable expectations of a rational third party. Which in turn would lead to that the conflict of interest between the management and the third party persists and a lack of confidence towards the management is established.

Increased costs, time, effort and resources along with enhanced education and long learning curve are other expressions that the investors believe will follow regulations on mandatory rotation of audit firms and affect and decrease audit quality. Both the company and the audit firm has to spend time, effort and resources on educating the new audit firm when a rotation would be made, which implies increased costs for both organizations. The education must be done properly in order to assure that the auditor meets expectations and complete work as the traditional definition of audit quality suggests, according to Cameran and Pettinicchio (2011): to detect irregularities and to report such irregularities. Further more, these expressions may also be linked to the public perceptions and third part expectations that is mentioned in the Policeman Theory and the Theory of Inspired Confidence, since a failure of educating the new audit firm would mean that the auditors do not reach expectations and that there is a decrease in audit quality. The failure of educating the new audit firm would lead to a failure to comply with the public perception, a failure to provide increased credibility in the financial statements, and a failure to reach the reasonable expectations of a rational third party, which in turn would lead to a lose of trust in

the auditor, a lose of faith and lack of confidence in management, and a conflict of interest between management and a third party.

6 Discussion

The investors in both the EU and the US use similar arguments to oppose mandatory rotation of audit firms, especially when it comes to auditor independence and audit quality. The legislators in the EU and the US want to achieve the same purpose: enhance auditor independence and increase audit quality. Nevertheless, the legislators have chosen two contradictory approaches.

Even though there are cultural and political differences between the EU and the US, the investors' viewpoints on mandatory rotation do not differ. Nevertheless, the EU chose to adopt regulations on mandatory rotation and it will indirectly affect the US, or more specifically US companies who have subsidiaries in Europe. If the company group wish to have the same audit firm throughout the whole organization, the parent company have to rotate audit firm as the same time as its subsidiary. In turn, it will affect the current regulation of audit partner rotation, especially in the US. A US company group who have subsidiaries in Europe and wish to have the same audit firm throughout the organization would have to rotate audit partner rotation every 5 years and also audit firm every 10 years, which could be synchronized but still would increase costs, effort, and resources for the company.

However, the costs and benefits of regulating mandatory rotation of audit firms are hard to measure. The same goes for audit quality, auditor independence, and auditor objectivity. The measurements are in the opinion and perspective of the viewer, however, as we can see in the empirical findings of this study the majority of the opinions agreed that the costs exceeded the benefits if regulating mandatory rotation. Another aspect that needs to be considered is the competitive advantage or disadvantage that follows such regulations. Companies outside of Europe who want to start up a subsidiary in Europe but dislikes the regulations on mandatory rotation of audit firms might put the subsidiary in an european non-EU country instead of Sweden, for example.

What could the reasons be behind the EU legislators' decision to adopt mandatory rotation of audit firms? Was it to take a lead in the global discussion of the problem with auditor independence? If that was the case there are still no evidence that mandatory rotation of audit firms would enhance auditor independence. The European Commission might has found a solution to the wrong problem, or the wrong solution to a non-existent problem. According to the Garbage can model by Cohen, March and Olsen (1972), the decision-making is loosley coupled between problem, solutions and decision makers in contrast to the rational decision making model. Furthermore, the garbage can model is often used during periods of crises and changes (Cohen, March & Olsen, 2012). The Green Paper, including the proposal of mandatory rotation, was published as a response to the financial crisis and the decision to regulate mandatory rotation could therefore be seen as an irrational decision. Another angle is that the EU wants to exercise their power and make a stand to show the member states who is in charge. A final aspect could be that the European Commission only wants to increase the independence in appearance, even though the independence in fact might not change. As Michel Barnier, the European internal market and services commissioner, said in 2012, "Just like beauty, quality and independence are in the eye of the beholder, therefore perception of audit quality and of auditor independence is paramount" (Hayes et al., 2014, p. 93). The independence in appearance could likely be increased by the EU regulation on mandatory rotation because the public would be assured that public interest entities would not have the same audit firm for a longer period, which could be seen as an improvement to auditor independence.

6.1 Further Research

Throughout the study we recognized information that could lead to further research in the subject. First of all, to make a study from other perspective than the investor's. Either to compare the viewpoints between the EU and the US from another stakeholder's point of view or to find out which stakeholder's, or stakeholders', arguments the EU followed when they decided to adopt regulation on mandatory rotation of audit firms. Secondly, to make a study on the affects of mandatory rotation of audit firms. This would be either to compare statistics to see if the rotations have been more frequent after the implementation of the regulation or to find out if the regulation has increased audit quality and/or enhanced auditor independence. Finally, a study could be made with the focus on one country. It could then compare viewpoints of stakholders within a country, compare statistics to see if the rotations are more frequent, or to find out if audit quality and/or auditor independence have been enhanced.

7 Conclusion

Is there a difference between the investors' viewpoints of mandatory rotation of audit firms in the EU and the US?

This study has concluded that there is almost no difference between the viewpoints of investors in the EU and investors in the US. In the EU only two organizations supported the regulation on mandatory rotation of audit firms while 20 opposed the same regulation. In the US all of the 20 investors' replies that were interpreted opposed such regulation.

Do the investors believe that regulations on mandatory rotation of audit firms will increase audit quality and/or auditor independence?

The majority of the investors in this study do not believe that regulations on mandatory rotation of audit firms will neither increase audit quality nor enhance auditor independence. Many investors rather believe that a mandatory rotation leads to a lack of knowledge and competence of the newly appointed audit firm and a decrease in audit efficiency and effectiveness. Also, that the regulation would lead to increased costs, time, effort and resources for both the company and the audit firm due to the enhanced education and the long learning curve of the new auditors. The failure to educate the new auditors would lead to increased risk of audit failure. Regarding auditor independence, most investors believed that the current regulations of rotating the lead audit partner are sufficient. However, mandatory rotation of audit firms might enhance auditor independence in appearance towards external parties.

Have the investors' viewpoints and arguments had any impact on the legislators in the EU and the US when they decided to choose two opposite approaches when it comes to regulating mandatory rotation of audit firms?

Furthermore, the study shows that the investors' viewpoints may have had an impact on the legislators' decision in the US since the legislators passed a bill of prohibition that prohibits future regulations on mandatory rotation of audit firms. However, it does not show that the EU investors' viewpoints have had an impact on the legislators in the EU since they decided to adopt the regulation. On the other hand, it does not show that the EU investors' viewpoints have not had an impact either. If they had an impact, the legislators in the EU chose to ignore the viewpoints of the investors.

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Appendix I – Respondents in the EU

Organization	Support/Oppose
Alliance Trust	Oppose
Association of British Insurers	Oppose
Association of Pension Funds Management Companies	Oppose
Aviva	Oppose
Blackrock Inc.	Oppose
CalPERS	Oppose
CFA Institute	Oppose
Danish Shareholders Association	Support
Deutsches Aktieninstitut	Oppose
Eumedion	Oppose*
German Insurance Association	Oppose
Hermes Equity Ownership Services	Oppose**
International Corporate Governance Network	Oppose
Investment Management Association	Oppose*
Irish Funds Industry Association	Oppose
Local Authority Pension Fund Forum	Support
National Association of Pension Funds	Oppose
Ralipen Investments	Oppose
Slovak Insurance Association	Oppose
Standard Life Investments	Oppose
Swedish Shareholders Association	Oppose
The British Venture Capital Association	Oppose

* = if other options did not help, mandatory rotation could be a solution

** = support fixed terms but not mandatory rotation

Table over the names of the organizations that replied to the European Commission's Green Paper and if the organizations supported or opposed mandatory rotation of audit firms.

Appendix 2 – Respondents in the US

Organization	Support/Oppose
Aflac	Oppose
Allied World Assurance Company	Oppose
American Council of Life Insurers	Oppose
Assurant	Oppose
Assured Guaranty Ltd.	Oppose
BlackRock Inc.	Oppose
Blackstone Group	Oppose
British Columbia Investment Management Corporation	Oppose
Capital Research and Management Company	Oppose
Federated Investors, Inc.	Oppose
Flaherty & Crumrine Funds	Oppose
Fidelity Investments	Oppose
Investment Company Institute	Oppose
Meadowbrook Insurance	Oppose
MFS Investment Management	Oppose
New York Life Insurance Company	Oppose
Pacific Life Insurance Company	Oppose
State Street Corporation	Oppose
The Hartford Financial Services Group	Oppose
Unum Group	Oppose

Table over the names of the organizations that replied to the PCAOB Concept Release and if the organizations supported or opposed mandatory rotation of audit firms.