

The Introduction of Mandatory Audit Firm Rotation in the EU: the Case of Portugal

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Abstract

A central issue in audit regulation is whether the introduction of mandatory audit firm rotation enhances audit quality. This paper contributes to the ongoing debate surrounding this issue by analyzing how senior auditors of one of the Big Four accounting firms in Portugal perceive the policy. This study adopts a qualitative methodology based on semi-standardized interviews. In general terms, the interviewees perceive mandatory audit firm rotation negatively due to the loss of client-specific knowledge it causes, the limited association between audit independence and tenure, and the resulting decrease in fees potentially harmful to audit quality.

Keywords: Mandatory Audit Firm Rotation, Audit Quality, Perceptions, Big Four.

1. Introduction

Statutory audits (hereinafter audits) provide a certified opinion on the accuracy of companies' financial statements. They contribute to the well-functioning of the financial markets, since they enhance market confidence and protect the different market players, like shareholders and investors, from agency risk. Reduced agency costs result in safer investments, so investors demand lower risk premiums due to lower company-specific risk arising from asymmetrical information (Quick and Schmidt, 2018). Nevertheless, these benefits can only emerge if market participants can indeed rely on statutory auditors' (hereinafter auditors) work (ibid).

The global financial crisis exposed massive losses from 2007 to 2009 on the position's banks had held both on and off-balance sheet (European Commission, 2010). This raised a doubt on the reliability of audit quality and created a debate on the need of a reform of the European Union (hereinafter EU) audit market, in order to restore public trust, financial stability, and implement a more suitable legislation framework. The EU legislation providing a new regulatory framework for statutory audit entered into force on 17 June 2016. The Audit Directive 2014/56/EU and Regulation (EU) No 537/2014, applicable in the 28 Member States of the EU, Iceland, Lichtenstein, and Norway, made the mechanism of mandatory audit firm rotation (hereinafter MAFR) a reality for the Public Interest Entities (hereinafter PIEs) of the European market. In Portugal (an EU member state) it has become a requirement that an audit firm of a PIE rotates every eight or nine years. Therefore, the focus of this paper is to analyze and explain the position of senior auditors of one of the Big Four accounting firms in Portugal regarding the implementation of a MAFR policy.

The next section provides the theoretical background by reviewing the literature on MAFR. Then, methodology is explained, followed by a presentation of the research's main findings. The last section contains the final conclusions reached from the analysis, as well as the limitations of the study.

2. Literature Review

MAFR consists in the "imposition of a limit on the period of years in which a particular registered public accounting firm may be the auditor of record for a particular issuer" (PCAOB, 2002, p. 775). The European Commission (hereinafter EC) (2014, p. 6) argues that MAFR improves audit quality because it "(...) will help reduce excessive familiarity between the statutory auditor and its clients, limit the risks of carrying over repeated inaccuracies, and encourage fresh thinking, thus strengthening the conditions for genuine professional skepticism".

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In contrast, the United States General Accounting Office (hereinafter US GAO) (2003, p. 2) advocates that MAFR “(...) may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company’s previous auditor of record”. The arguments presented by the two institutions have been repeatedly discussed in the last decades. However, little consensus has been achieved on whether the overall effects of MAFR on audit quality are positive or negative.

DeAngelo (1981a, p. 186) defines audit quality as the auditor’s capacity to both “discover a breach in the client’s accounting system” and “report the breach”. While the former depends on factors such as the auditor’s technological capabilities and the procedures used, the latter is a measure of an auditor’s independence from a certain client (*ibid*). This suggests that auditor independence has a positive impact on audit quality.

Auditor independence is threatened by the existence of client-specific quasi-rents to incumbent auditors (i.e. incumbent auditors can charge future audit fees above the avoidable costs of auditing). These quasi-rents result from certain aspects of the audit environment (e.g., considerable start-up costs and high costs of changing auditors) that give incumbent auditors cost advantages over competitors in future audits of a client (DeAngelo, 1981b). As competition to become the incumbent auditor leads them to set audit fees below total current costs on the initial period (i.e. low balling), the audit engagement works as an investment for the auditor (*ibid*). Logically, the higher the future quasi-rents are, the higher the economic incentive to continue the auditor-client relationship and to cover a breach in the client’s financial statements. Implicitly, DeAngelo shows that an unlimited relationship between an auditor and a client can weaken audit quality. This effect is stronger in small audit firms, since larger ones have “more to lose” in terms of reputation and future client revenues if they do not report a discovered breach (DeAngelo, 1981a).

While DeAngelo’s (1981b) analytical research indicates a potential benefit from a mandatory rotation policy, Arruñada and Paz-Ares’s (1997) analytical research concludes the opposite. As a consequence of lower incentives to invest in client-specific knowledge and less specialization of the audit firms, audit quality is expected to decrease (*ibid*). Moreover, the increase in transaction costs is substantial, both for the audit firm (e.g., time to familiarize with the client’s accounting procedures, operations, control systems, verifying the initial balance sheet figures, etc.) and for the companies audited (e.g., time choosing an audit firm, defining contract conditions, supplying resources for a first audit, etc.). Costs from changing the audit firm, like the impact on the company’s stock price or the loss of trust, are also a disadvantage (*ibid*). According to the US GAO (2003, p. 6) the “initial year audit costs under mandatory audit firm rotation would increase by more than 20 percent”.

Differently, Gietzmann and Sen (2002) and Bowlin et al. (2015) advocate for a rotation policy in some specific cases only. On the one hand, Gietzmann and Sen (2002) only recommend mandatory rotation in markets with relatively few large clients, where a single client may represent a big portion of the auditor’s income (i.e. fees). In this type of markets, as auditors have more incentives to retain clients, they are more vulnerable to client pressure, hence colluding with management is more likely. Nonetheless, in a sufficiently developed market, concerns with reputation tend to dissuade collusion, meaning that a rotation policy would mainly result in unnecessary costs (*ibid*). On the other hand, Bowlin et al. (2015) argue that the effects of mandatory audit partner or firm rotation are positive or negative depending on the auditor’s “professional skepticism” (i.e. a mind-set of questioning audit evidence and evaluate/judge it critically). If auditors assess the potential honesty of managers (e.g., client integrity assessments), rotation decreases auditor trust on managers, raises audit effort, and reduces audit failures. Nevertheless, if auditors have a “skeptical mindset” and assess the potential dishonesty of managers (e.g., fraud risk assessments), rotation increases auditor trust, lowers audit effort, and increases audit failures (Bowlin et al., 2015). Consequently, under mandatory rotation, the usual benefits from a “skeptical mindset” might be reversed and auditors might be unconscious of this, since an auditor’s skepticism orientation is a “subtle psychological effect into which decision makers rarely have accurate insight” (*ibid*, p. 28).

2.1 Independence in Fact and in Appearance

As the primary purpose of MAFR is to increase auditor independence, and consequently audit quality, some authors have mainly investigated the effect of the policy on independence (Sayyar et al., 2014). With few exceptions (e.g., Summer, 1998), most studies focusing on auditor independence reveal positive benefits from MAFR.

For the purpose of studying independence in particular, experimental research has been used to analyze causal relationships in controlled settings (Ewelt-Knauer et al., 2012). Due to the limited time to establish an auditor-client relationship able to undermine independence, auditors are more likely to issue unbiased reports under mandatory rotation (Dopuch et al., 2001). As the client retains the auditor, the latter can benefit from lower marginal costs in the subsequent audits and from synergies from also supplying non-audit services (*ibid*). Notwithstanding, Dopuch et al. (2001) claim that these economic rents may jeopardize auditors' independence since there are incentives to avoid the contract's termination agreeing in this regard to DeAngelo's (1981b) standpoint.

Additionally, the long tenure of the audit firm can affect audit quality due to excessive familiarity with the client, insufficient attention to detail thanks to staleness and redundancy, and more willingness to satisfy client's requests (Arel et al., 2005). Arel et al. (2006) also find that a rotation policy raises audit quality because an auditor under it (especially in the last year before rotation) is more likely to go against the client's preferences and to record something that the client refuses to disclose. Comparing to a scenario without rotation, auditors have less incentives to retain the client, making them more independent in the analysis of the client's records (*ibid*). Likewise, Wang and Tuttle (2009) conclude that auditors are in a better position to negotiate with the clients in a MAFR regime, which can protect the independency of results. However, as auditors follow less cooperative negotiation strategies, negotiations impasses are more likely (*ibid*). Hatfield et al. (2011) also put in evidence the benefits from mandatory rotation since their experiment demonstrates that auditors not previously involved in the audit process recommend significantly larger audit adjustments than auditors previously involved. However, client pressure, which affects the proposed audit adjustments, seems not be mitigated by a rotation policy (*ibid*).

According to Fearnley and Beattie (2004), loss of trust in the audit process not only occurs when an audit fraud is detected (loss of independence in fact), but also when there is a perception of auditor misbehavior (loss of independence in appearance). This highlights "(...) the importance of independence in appearance because independent behavior is unobservable" (*ibid*, p. 121). Likewise, independence in fact, MAFR might affect independence in appearance, but in different ways depending on the background of the participants involved in the audit process (Ewelt-Knauer et al., 2012). A sample of 49 American judges shows that independence in appearance is higher in a regime with MAFR than in a regime with mandatory audit partner rotation (Jenningsetal., 2006). Gates et al. (2007) reach the same conclusion when using a sample of Master Business Administration and law students from a top ranked US University. A similar conclusion was reached in a study of a sample of 212 bank loan officers in the United States (US) by Daniels and Booker (2009) – MAFR improves auditor independence perceptions compared to a regime without rotation. In the UK, long audit tenures also decrease investors' perceptions of auditor independence, but "auditors' economic dependence upon its client" and the "joint provision of audit and non-audit services" are perceived by the investors as larger threats (Dart, 2011, p. 183). In contrast, Kaplan and Mauldin (2008) find that MAFR does not enhance independence in appearance among non-professional investors comparing to audit partner rotation, while Aschauer and Quick (2018) conclude that for professional investment consultants at banks, a rotation regime does not have a significant influence on independence in appearance.

2.2 Audit Tenure

A considerable portion of the literature on MAFR corresponds to archival research that typically investigates the relationship between audit tenure and a proxy for audit quality (e.g., audit failures, audit opinions, and discretionary accruals), but not auditor independence directly (Ewelt-Knauer et al., 2012). The majority of these studies, which use historical data to make inferences, have been performed in the US and their results are conflicting and, therefore, inconclusive (*ibid*).

Several authors provide evidence that tenure is positively or at least not associated with audit quality (Geiger and Raghunandan, 2002; Johnson et al., 2002; Myers et al., 2003; Carcello and Nagy, 2004; Blouin et al., 2007; Gunny et al., 2007; Chen et al., 2008; Jenkins and Velury, 2008). The main explanation presented is the existence of a learning curve; this results in less audit failures in extended tenures because auditors become more expert in the industry and have more client-specific knowledge, which increases the likelihood of detecting misrepresentations and irregularities. Moreover, clients might have a bigger influence on auditors in the early years, reducing their independence and, consequently, the quality of the audits. In contrast, and despite being less numerous, some authors take the opposite view and use archival research to support rotation regimes.

For example, Deis and Giroux (1996) use 232 quality control reviews of public accounting firm audits of Texas as a proxy for audit quality and find a negative relationship between audit quality and the length of tenure. Additionally, Vanstraelen (2000) examines the impact of long-term audit mandates on audit quality using the annual

accounts of companies submitted to the Belgian National Bank between 1992 and 1996. The results indicate that long-term auditor-client relationships significantly raise the likelihood of the auditor to issue an unqualified audit opinion, suggesting that auditors become less independent as tenure increases. Nagy (2005) studies audit quality of companies forced to change auditors in the US between 2000 and 2003. Using discretionary accruals, instead of audit opinions, as a proxy for audit quality, he finds that audit quality increases (i.e. a decrease in discretionary accruals) for the small companies forced to switch auditors. Once again, the outcome suggests a positive relation between short tenure and audit quality. Lowensohn et al. (2007) further contribute to the literature by analysing State of Florida's audit environment where both rotation and non-rotation regimes exist. After controlling for factors potentially linked with report quality (such as size, growth patterns, and financial condition of the entities being audited), they conclude that entities following a rotation policy have less "financial reporting and auditing deficiencies" (p. 8) than entities opting for long-term relationships with auditors.

Moreover, there are also researchers whose studies report mixed results (Chi and Huang, 2005; Carey and Simnett, 2006; Li, 2010; Chi et al., 2011). Using Taiwanese listed firms between 1998 and 2001, Chi and Huang (2005) investigate the effect of audit tenure on the level of discretionary accruals and, consequently, on audit quality. The results support that familiarity is beneficial to produce higher earnings quality, but excessive familiarity leads to lower earnings quality. The year five appears as the cut-off point of positive and negative effect of familiarity. On the other hand, Carey and Simnett (2006) demonstrate that the inconsistent conclusions can also derive from the proxies used to measure audit quality. According to the study, if the proxy is the propensity to issue a going-concern audit opinion for distressed companies, audit quality decreases with tenure. Then, if audit quality is defined as exceeding earnings benchmarks, there is only partial evidence that it is negatively associated with a long tenure. Lastly, there is no evidence of an association between the length of tenure and abnormal working capital accruals, the third proxy defined. Regarding Li (2010), there is an extension of the already mentioned Jenkins' and Velury's study, who argue a positive relation between the conservatism in reported earnings and the length of tenure. Instead, Li (2010) supports that the positive relation is only present in large firms or firms strongly monitored by their auditors, whilst for smaller firms or firms weakly monitored by their auditors, the relation is negative. Lastly, Chi et al. (2011) conclude, from a sample of audits in the US between 2001 and 2008, that longer tenure is negatively associated with abnormal accruals (i.e. accrual earnings management), but positively associated with real earnings management. Therefore, only one of the outcomes (the latter) suggests potential benefits from a rotation regime.

Besides this, a few archival studies focus on the effects of audit tenure and perceived audit quality on capital markets. Mansi et al. (2004) find that audit quality and tenure are negatively related to the cost of debt financing. Since firms with long auditor-client relationships tend to receive better bond ratings, it is expected that capital markets perceive MAFR unfavorably, which will reflect negatively on the cost of capital. For Ghosh and Moon (2005), imposing restrictions on the length of tenure can also set unintended costs on capital market participants, such as investors and independent rating agencies. The results, derived from a sample of almost 40 000 US publicly traded companies, establish a positive association between tenure and investor perceptions of earnings quality. Moreover, there is evidence of a higher influence of reported earnings on stock rankings for longer tenures, whereas the association between debt ratings and reported earnings does not change with the duration of the auditor-client relationship. This gives some evidence that independent rating agencies see reported earnings of firms with longer tenures as more trustworthy. Nonetheless, Boone et al. (2008) find that the equity risk premium declines in the early years of tenure, whereas it rises with additional years of tenure. The result suggests that investors' perceptions of audit quality are nonlinear because they increase in the early years but decrease after a cut-off point ("possibly past thirteen years of tenure").

To conclude, it is indispensable to highlight the main limitations of archival research on audit tenure. In general, archival studies conclude that audit quality increases (or at least is not associated) with tenure, and that the early years of the auditor-client engagement are characterized by more audit failures, unqualified opinions, or higher discretionary accruals, depending on the proxy used to measure audit quality (Ewelt-Knauer et al., 2012). As a result, MAFR appears as a harmful policy. However, the vast majority of the studies leading to this inference use data from regulatory regimes where changing the audit firm is voluntary rather than mandatory (Casterella and Johnston, 2013). In other words, regulatory regimes where switching audit firm is an endogenous decision rather than an exogenous decision. This raises the doubt of how to which extent the conclusions reached in non-mandatory regimes verify in a mandatory regime (Geiger and Raghunandan, 2002; Johnson et al., 2002; Myers et al., 2003; Carcello and Nagy, 2004; Ghosh and Moon, 2005; Chen et al., 2008; Casterella and Johnston, 2013).

For example, Johnson et al. (2002) explain that the results of lower audit quality found in short tenures also occur in a mandatory regime if its cause is lack of client-specific knowledge. On the other hand, if the decline in quality is because of incentives to capture future economic rents from the client, a mandatory rotation policy is likely to reduce the problem. Likewise, Ghosh and Moon (2005) advocate different incentives for auditors and clients in the two regimes as a potential factor limiting the transferability of results to a mandatory regime. Furthermore, audit firms tend to resign from riskier clients, which is consistent with the risk avoidance theory of audit firm portfolio management (Johnstone and Bedard, 2004). Consequently, since companies switching auditors tend to be the ones with higher risks, the occurrence of more financial reporting problems in short tenures in a voluntary regime do not necessarily indicate problems with the audit process itself in the early years of the auditor-client relationship (Carcello and Nagy, 2004). In this context, Li (2010, p. 239) makes an important contribution to the literature because he appears as one of the few that has taken into account in his study the self-selection bias emerging from using voluntary data: “(...) in this study I control for an endogeneity problem possibly arising from the auditor tenure variable, which is often ignored in previous studies”.

2.3 Audit Market Concentration

The high degree of concentration in the audit market is also one of the concerns of the EC. According to the EC (2010, p. 15), audit market concentration “might entail an accumulation of systemic risk” and it denies “client’s sufficient choice when deciding on their auditors”. As a result, MAFR intends to increase dynamism in the audit market and, ultimately, reduce its concentration (EC, 2014). Nevertheless, Arruñada and Paz-Ares (1997) defend that a rotation rule is unlikely to change the market share of the different participants, and Cameran et al.’s (2005) findings sustain that MAFR has contributed to higher concentration among the biggest audit firms in Italy, where the policy was implemented in 1975.

Besides this, US GAO (2003, p. 35) reveals that “no empirical evidence of impaired competition” was found due to high concentration in the audit market and later, it restates the inexistence of evidence that justifies measures to reduce audit market concentration (US GAO, 2008). Moreover, Kallapur et al. (2010) and Francis et al. (2013) identify a positive relation between audit market concentration and audit quality, which advocates that a policy reducing concentration is not needed.

2.4 Countries with Mandatory Audit Firm Rotation

Another stream of the literature analyses the results of a MAFR regime on countries that have experienced it, instead of using voluntary audit firm rotation data to make inferences. Until recently, the policy has not been implemented in many countries, which is why there are only a few studies using true mandatory settings (Lennox et al., 2014; Cameran et al., 2015).

In Spain, from 1988 to 1995, audit firm rotation was mandatory every nine years, but after only seven years, in 1995, the policy was discarded (Ruiz-Barbadillo et al., 2009). Ruiz-Barbadillo et al. (2009) use anyway a sample of Spanish financially distressed firms to study the impact of MAFR on auditor behaviour, and consequently on audit quality, during two periods: from 1991 to 1994 (in a MAFR regime) and from 1995 to 2000 (in a voluntary audit firm rotation regime). The results do not support the rotation policy, since no evidence is found that the policy increases the likelihood of auditors issuing a going-concern opinion (*ibid*). This may indicate that the market itself has mechanisms, like concerns with reputation that protect audit independence.

In South Korea, MAFR was in force between 2006 and 2010 (Kwon et al., 2014). Using a sample of Korean public listed firms from 2000 to 2009, Kwon et al. (2014) verify that audit quality did not change for companies that were mandatorily rotated comparing with companies that were voluntarily rotated before and after 2006. Moreover, after 2006, audit fees raised in general for the entire audit market (i.e. for companies that were mandatorily or voluntarily rotated and for companies that continued engagements), which means that the overall increase in costs outweighed the increase in benefits (*ibid*). In contrast, comparing the periods before and after introducing MAFR in South Korea and Brazil (where MAFR started in 1999), Harris and Whisenant (2012) find less earnings management after the introduction of the policy. Additionally, using data from Italy, South Korea, and Brazil, these authors find lower audit quality in the specific years before and after rotation, an outcome that contradicts Orin (2008) and Lennox et al. (2014) (see next section).

While the first outcome suggests an increase on auditor independence, and a consequent increase on audit quality, due to the policy, the second outcome may partially be explained by lack of client-specific knowledge (Harris and Whisenant, 2012).

Finally, evidence from Italy, where a nine-year MAFR policy is in force since 1975, does not support the policy (Cameran et al., 2015). Using publicly listed companies in Italy between 2006 and 2009, the researchers conclude that there is a decrease in audit quality, represented by an increase in abnormal working accruals, in the initial three years after mandatory rotation, comparing to later years of tenure. This negative outcome, potentially due to the learning curve effect, does not come alone, as the policy also increases audit fees.

2.5 Mandatory Audit Firm Rotation vs Mandatory Audit Partner Rotation

As a rotation policy generates substantial costs, it is indispensable to clarify whether it results in fact in measurable benefits (Bamber and Bamber, 2009). In a MAFR regime, the end of a mandate implies not only a new firm and audit team, but also potentially new audit methodologies and client procedures. Nonetheless, a regime with partner rotation in most cases only switches one or a few auditors, which is substantially cheaper (Bedard and Johnstone, 2010). On the other hand, audit partner rotation does not assure audit independence, because it may come from the audit firm's culture itself and not from the auditor(s) changed. Notwithstanding, it preserves client-specific knowledge without incurring in new large start-up costs (Bamber and Bamber, 2009). In a few words, the costs and benefits of both regimes are significantly different.

According to Orin (2008), MAFR is more beneficial because it provides more competition in the audit market and it strengthens both independence in fact and appearance. Three main arguments put in evidence weaknesses of the audit partner rotation requirement comparing to the audit firm rotation requirement in the US audit market (ibid). Firstly, a new audit firm, comparing to a new auditor from the same company, has more financial and legal (self-protection) incentives to report and correct accounting failures detected from the previous mandate. In the same vein, an incumbent auditor has more incentives to provide high audit quality if the following auditor reviewing the client's financial statements is from another firm. Secondly, the existence of policies similar to the audit partner rotation requirement in force in the US during major accounting scandals (e.g., Eron scandal) predicts the potential lack of effectiveness of auditor rotation. Thirdly, the report of the US GAO (2003) supporting audit partner rotation instead of audit firm rotation is based on a survey that has the Big Four companies, the agents with possible economic losses in case of a MAFR regime, as the main source of responses.

Fitzgerald et al. (2012) investigate the effect of MAFR and mandatory partner rotation on detecting and reporting internal control deficiencies, using a sample of large US not-for-profit organizations between 2001 and 2007. While the results show a considerable increase in reported internal control deficiencies in the first year following an audit firm rotation, they find no association between audit partner rotation and reported internal control deficiencies.

Finally, Lennox et al. (2014) show that audit partner rotation increases audit quality, especially in the year before and after mandatory rotation. This indicates that the incumbent auditor has incentives to leave the client's records "cleaned", while the viewpoint of a new auditor might detect unnoticed irregularities. Instead of focusing in comparing both rotation regimes, these researchers correct "(...) two key limitations of the prior literature" (ibid, p. 1781) in order to examine accurately the consequences of audit partner rotation. First, only mandatory partner rotation events were considered, thus refraining from the self-selection bias. Second, audit adjustments data was used, instead of noisy audit quality proxies such as "accruals and earnings response coefficients" (ibid, p. 1776). Chi et al. (2009) use those exact proxies to conclude that mandatory audit partner rotation may be limited in promoting audit quality. This way, Lennox et al. (2014, p. 1776) criticize the "(...) only one study on the consequences of mandatory partner rotation", before their own.

To sum up, addressing the effects of audit partner rotation on audit quality is also crucial to realize if a more restrictive and expensive policy, like MAFR, is indeed necessary.

3. Methodology

This paper seeks to answer the research question: "How do auditors perceive mandatory audit firm rotation in one of the Big Four audit firms in Portugal?". In broader terms, it intends "to understand and explain the specific, rather than to produce generalizations" (Ryan et al., 2002, p. 144). Due to its explanatory character, a qualitative methodology was followed. More specifically, seven interviews to auditors of a "big four" company (henceforth 'company ABC' to preserve confidentiality) operating in Portugal were conducted. The qualitative research interview, which has been used in numerous fields of study, is the most broadly used qualitative research method (Schultze and Avital, 2011).

Polkinghorne (2005, p. 138) states that “[t]he experiential life of people is the area qualitative methods are designed to study”, meaning that typically an interviewee’s experience, in this case an auditor’s experience in a regulated market, constitutes the focus of interest. Beasley et al. (2009) also highlight the usefulness of the interview method to collect detailed insights and investigate issues difficult to analyze under archival methods. Notwithstanding, “[t]he interview method can reveal more subtle threats to objectivity, such as those arising from personal friendships with management that may not be identified through archival methods” (ibid, p.72).

Lune and Berg (2017) define three types of interviews in terms of the degree of rigidity regarding the presentational structure. First, a standardized interview, uses a formally structured script of interview questions that does not allow deviations from question order or adding extra questions. It is appropriate when questions are simple/direct, and no additional clarifications are required. Second, an unstandardized interview, is loosely structured, meaning that although certain topics are scheduled, no specific questions have to be asked, and, depending on the respondent’s answers, the course of the interview varies significantly. It is suitable, for example, during the course of a field research where ongoing informal interviews are a good complement to field observation. Third, a semi-standardized interview, is an in-between type. Although a number of questions usually asked in a systematic and consistent order for the different respondents are prearranged, unplanned questions or further clarifications emerging from the interview process itself can also be included. For the present study semi standardized interviews were applied, since the topic was too complex for a standardized interview and inadequate for an unstandardized interview, for example due to the difficulty in comparing the qualitative data and infer conclusions from it.

Following prior literature, an interview script was prepared to conduct the interviews (see Appendix 1). The questions were formulated in a way that did not guide the interviewees to a particular answer, giving them space to be more descriptive, detailed, and honest. For example, instead of starting a question by “Do you think that...?”, they were asked the questions in a more open way, for instance “How do you predict...?”/ “What do you perceive...?”.

Regarding the interviewees, they were all partners or senior managers of company ABC, who have been working as auditors between eleven and thirty-three years and have experience with both listed and non-listed clients.

Interviewees and Interviews Data

Interview	Date	Location	Duration (minutes)	Auditor for	Auditor of
1	04/12/2018	Company ABC	30	18 years	Non-financial companies
2	05/12/2018	Company ABC	36	19 years	Financial companies
3	06/12/2018	Company ABC	26	33 years	Non-financial companies
4	01/04/2019	Company ABC	41	11 years	Non-financial companies
5	03/04/2019	Company ABC	22	12 years	Financial companies
6	09/04/2019	Company ABC	31	16 years	Non-financial companies
7	13/04/2019	Company ABC	17	18 years	Non-financial companies

Five out of the seven are auditors of non- financial companies, while the remaining two are auditors of companies within the financial sector. Each auditor was interviewed in person and individually for an average of 29 minutes, while the shortest interview took 17 minutes and the longest took 41 minutes. The interviews, amounting in total to 203 minutes, were performed between December 2018 and April 2019. The interviews were in Portuguese since it is the native language of the participants and the one, they mostly use in their job. Before each interview, the respondents were informed that their answers would be held in confidence and only used for academic purposes in

order to strengthen openness and honesty. With the consent of the participants, the interviews were taped and then transcribed, first to Portuguese and later to English. Besides the obvious advantage of retaining the entire information of the interviews, taping them allows the interviewer to better conduct the conversation and engage with the respondent (Harvey, 2011). This is particularly important in a context of semi-standardized interviews where the path of the interview can lead to temporary deviations from the predetermined questions.

The qualitative data from the interviews was interpreted according to the guidelines of Miles et al. (2014). The authors define analysis “as three concurrent flows of activity” (ibid, p. 31): Data condensation – the process of selecting, done by highlighting in bold the most relevant parts of the interviews; Data display – the process of organizing, done by reading repeatedly the interviews and drawing displays summarizing the selected data; Conclusion drawing/verification – the process of interpretation, done by highlighting with colors the displays built in order to combine information and find patterns/repetitions.

4. Empirical Study

This section presents the results of the interviews conducted, as well as a comparison between them and their interpretation in light of the literature review. The results of each question were analyzed through the displays built from the interviews transcript, which allow for a better understanding of the qualitative data, since “[e]xtended text overloads our information-processing capabilities and preys on our tendencies to find simplifying patterns” (Miles et al., 2014, p. 32).

The first question (“in a regime without rotation an audit firm can see a client as an unlimited source of revenue. What are the consequences of this in terms of audit quality?”) addresses a scenario without a MAFR policy, in order to explore issues discussed by DeAngelo(1981b) and Arruñada and Paz-Ares (1997), namely incentives to avoid contract’s termination with a client versus incentives to invest in client-specific knowledge.

Five out of seven (interviewees 1, 2, 3, 5, and 7) claim that the prospect of having a client forever does not influence by itself audit quality. Furthermore, respondents 1, 3, and 5 say that it is the delivery of good quality that makes a client to stay, and respondents 3 and 7 also argue that audit quality results mainly from effective internal quality control. In this regard, interviewee 1 clarifies that “(...) the relationship would only last if there was investment and deliver of quality”, whereas interviewee 3 states that “(...) company ABC, like any Big Four, has internal quality control every year organized by the international main office. Consequently, I don’t see the inexistence of rotation as harmful for quality”. Auditors 2, 3, 5, and 6 add that the risk to please a client does not change with a MAFR policy. For example, interviewee 2 and 6, respectively, mention:

“Being an unlimited source of revenue was never relevant, from my own experience, to be more or less flexible in the work done” and *“[t]hat risk (of pleasing the client) always exists with or without rotation (...) So, I don’t think the policy mitigates this risk”*.

However, interviewee 6 concludes that there is an overall positive effect on quality because of “(...) *higher propensity to invest if you know that you have a longer period to recover from an investment*”. Finally, only interviewee 4 agrees with DeAngelo (1981b): “(...) *the reasoning is if I don’t have a time limit to stay with this client (...) I won’t do an audit by the book, I’ll adjust to the clients’ needs to ultimately avoid losing it*”.

The second question assesses the effects of tenure on audit quality (“how would you describe the effect of tenure of the auditor-client relationship on audit quality?”). Like in the literature review, the great majority of the respondents advocates benefits from long tenures:

“(...) in a rotation process there is loss of knowledge” (interviewee 1); *“So as you are more time in the same client, you get more foundations to do your job correctly”* (interviewee 2); *“(...) an audit firm in the same client for a long time understands the business deeply, (when rotation occurs) all knowledge is left behind”* (interviewee 6). Besides this, interviewees 2, 3, and 6 mention the existence of internal policies of mandatory rotation of auditors to mitigate potential disadvantages from long tenures, like the ones Vanstraelen (2000) or Arel et al. (2005) find, namely insufficient attention to details and more willingness to satisfy client’s requests. According to respondent 6, *“(...) audit firms anticipated that risk (perpetuity in clients) before the implementation of MAFR. (...) internal rules of Big Four require rotation of the auditors responsible for the work”*.

Moreover, auditors 2, 5 and, 7 raised the same issue as Ewelt-Knauer et al. (2012) by recognizing that the likelihood of audit failures is higher in the early years of tenure, especially in complex companies.

Concerning this, interviewee 5 explains that “*there are such complex companies where (...) you have to incur in high start-up costs that may not be met in the first and second years*” and interviewee 7 states that “[*a*] *first or second year auditor isn’t able to have a complete perception of a company*”.

The third question refers to the topic of independence (“*how do you predict the impact of MAFR on auditor independence in fact? What about in terms of independence in appearance?*”). Regarding independence in fact, some respondents do not associate it with tenure and, consequently, they do not expect MAFR to increase it: “*(...) it’s not because you only have four years in that client or twenty that you will be more or less independent*” (interviewee 2); “*(...) it’s something that must arise from the auditor*” (interviewee 5); “[*i*] *independence depends on internal norms, depends on oversight*” (interviewee 7).

As suggested by these quotes, they argue that lack of independence can also happen in the early years, so it depends on professional’s standards and internal/external control. This goes against researchers such as Dopuch et al. (2001), Wang and Tuttle (2009), or Hatfield et al. (2011) whose studies support an increase in independence in a MAFR regime. In contrast, respondents 4 and 6 support a positive effect of MAFR on independence and admit that a client moving to a competitor audit firm can have some impact on the work performed, as suggested by Arel et al. (2006) and Orin (2008). Interviewee 6 in particular emphasizes “*(...) you will be more exposed since a new audit firm will replace you, as you will be more exposed you will be more careful in the key topics. In the end, you will be more independent because you have more people looking to the same things, so you will be more careful, more focused*”.

In terms of independence in appearance, results are more in line with literature review. As suggested by Fearnley and Beattie (2004), interviewee 1 considers it a highly important topic: “*(...) public trust (...) has been negatively affected. As a result, measures that intend to improve it are welcome*”. However, in the same vein of Kaplan and Mauldin (2008), Dart (2011), and Aschauer and Quick (2018), auditor 1, as well as 7, does not expect an improvement in independence in appearance, since “*(...) MAFR already existed in several countries where there wasn’t a better perception of the auditor*”. On the other hand, the remaining respondents support the positive effects on independence in appearance that Jennings et al. (2006), Gates et al. (2007), and Daniels and Booker (2009) refer to. Within this framework, interviewee 3 refers that “*(...) the policy is able to in fact enhance it (independence in appearance) because the market doesn’t know our internal controls*”, while interviewee 6 considers that “*(...) it brings a feeling of transparency to the market which is positive*”.

The fourth question concerns the consequences of MAFR on market concentration (“*what do you perceive as the consequences of MAFR on audit market concentration?*”). The majority of the interviewees agrees with Arruñada and Paz-Ares (1997), meaning that they do not expect a significant change in market concentration, as companies will rotate among the Big Four because “*(...) there is a gap in quality between the Big Four and non-Big Four companies*” (interviewee 1) and/or “*(...) smaller companies don’t have capacity to hold a listed company as they don’t have the resources, the number of people (...)*” (interviewee 3). In contrast, auditor 2 adds that “*(...) there are already Big Four companies that don’t audit investment funds due to low fees*”, whilst auditor 4 thinks that “*(...) smaller clients will release themselves from big audit firms to smaller ones*”.

The fifth question intends to summarize the position of the respondents regarding MAFR (“*will MAFR enhance auditor independence, objectivity and professional skepticism, three foundations of quality audit?*”). The sample is formed by five opponents of MAFR (interviewees 1, 2, 3, 5, and 7), one supporter (interviewee 4), and a respondent that supports MAFR in a regime with minimum audit fees on tenders (interviewee 6). In fact, interviewees use the reduction of fees as the main argument for not supporting MAFR, since it leads to a reduction in teams, investment, and limits work to the minimum requirements, all of which contribute to a decrease in audit quality. In this regard, interviewee 2, 3, and 5 transmit similar ideas: “*That’s the most critical point of rotation (...) the price reduction results in smaller teams with less experience and skills and, consequently, work with lower quality*”; “*The only thing the policy will bring is a reduction of fees (...) eventually causing a reduction of quality*”; “*(...) the policy increases competition which reduces prices leading to less profitability or less quality in case of less investment*”. This contrasts with evidences of Kwon et al. (2014) from South Korea and Cameran et al. (2015) from Italy, where audit fees increased due to a MAFR policy. Moreover, auditors 3, 6, and 7 say that a MAFR policy treats audit as a commodity instead of an expertise service, which might also harm audit quality if companies choose audit firms solely based on a price criterion. In particular, interviewee 7 argues that “[*a*] *udit is increasingly seen as a commodity rather than an expertise service which makes most companies looking at fees*”.

The sixth question explores two topics: the most appropriate term length of tenure and the reasoning behind a tighter legislation in Portugal (“*knowing in advance that the policy exists, what would be the most appropriate term length? Why do you think National legislation went further than European Union by defining mandatory audit firm rotation every 8 or 9 years instead of every 10 years?*”).

Similarly to literature, the most appropriate term length has little consensus: interviewee 1 and 7, oppose MAFR, disagree with any period; interviewee 2 justifies that “(...) *it always depends on the client's dimension*”; interviewee 5 and 6, respectively, say that “(...) *ten years is reasonable*” and “(...) *the period defined seems reasonable to me*”; interviewee 3 claims that “*less than seven years, the internal rotation of auditors required by company ABC, would be infeasible*”; and interviewee 4 follows Chi and Huang (2005) view that “(...) *rotation should occur every five years*”. Regarding the rotation period defined in Portugal, respondents explain it with political reasons and/or the fact that the mandates of the Board of Directors, Audit Committee, and Statutory Auditor have a duration of three or four years. This implies that to comply with law, a company can have the same audit firm for three mandates of three years or two mandates of four years.

The same way that authors such as Orin (2008), Bamber and Bamber (2009), and Fitzgerald et al. (2012) compared the effects of MAFR with other policies, namely mandatory partner rotation, the last question focus on finding alternatives to MAFR (“what alternatives, if any, would you propose to MAFR?”). As a broader question, answers are more diverse/heterogeneous. Nevertheless, they appear to have basically two goals: meet market expectations; and increase independence.

5. Conclusions

The main purpose of this study was to explain how senior auditors of one of the Big Four multinational accounting firms operating in Portugal perceive MAFR. The seven interviews conducted addressed the main issues under ongoing debate among researchers, regarding on whether the overall effects of the policy are positive or negative. In general terms, the interviewees perceive MAFR as damaging the market, since they relate long-term tenures with crucial client-specific knowledge; they do not associate tenure with lack of independence (in fact); they do not expect a significant change on market concentration as regulators intended; and they predict the decrease in fees from stronger competition to impair audit quality. Despite the foreseen positive effects on independence in appearance, interviewees proposed alternatives to MAFR mostly aiming to increase independence (in fact and in appearance) in a less costly way, namely through restrictions on non-audit services, joint audit arrangements, mandatory partner rotation, and more detailed audit reports.

As a consequence of the research's qualitative nature, statistical generalizations cannot be inferred. Moreover, the study's wide scope, as well as the sample size, might have limited an exhaustive approach of all subjects. However, this is in line with the methodology adopted as “the case study represents a preliminary investigation, which is intended to generate ideas and hypothesis for rigorous empirical testing at a later stage” (Ryan et al., 2002, p. 144). Besides, as data relies on a single audit firm from one European country, results may be biased due to firm or nation specific factors, such as the company's culture and the legal environment, respectively. Finally, audit legislation has imposed other limitations in addition to MAFR, hence further research on the joint effect of these reforms might be important in order to evaluate their overall effectiveness in restructuring the European audit market and, ultimately, increase audit quality.

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