



# The impact of auditor rotation on audit quality

A qualitative study conducted with audit companies and public listed companies located in Sweden

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## Abstract

The collapse of Enron and several other companies, such as Global Crossing and the more recent scandal of Tesco, raised concerns worldwide about auditor independence and audit quality. The scandals have proven that particularly the joint-provision of auditing and non-audit services (NAS) along with a long-term auditor-client relationship tend to adversely impact auditor independence thus audit quality, triggering the need for a new regulation. In order to solve this problem, the European Union implemented a new regulation requiring public listed entities (PIEs), which are defined as listed companies, credit institutions and insurance undertakings, to rotate their audit firm after a period of 10 financial years. The primary purpose of my master thesis is to gain a deeper understanding of audit firms' and public listed firms' perceptions of auditor rotation, meant in the sense of audit firm rotation, and its impact on audit quality. More specifically, I aim to investigate whether audit firm rotation enhances audit quality due to a fresh view brought to the company audited by a new auditor or lowers it because of a new auditor's lack of knowledge about the client's industry.

Current literature regarding the new EU regulation, audit firm rotation and its impact on audit quality as well as the early stage of implementation of the new EU Directive in Sweden helped me to recognize a research gap. Existing studies similar to mine have not been concerned with getting a deeper understanding about the perception of this topic by audit companies and public listed companies located in Sweden. The research philosophy of my study is based on the constructivist ontological view and interpretivist epistemological perspective. In addition, the deductive approach is used to study the research question, while applying the qualitative research method by carrying out multiple semi-structured interviews with auditors and CEOs (Chief Executive Officers) and CFOs (Chief Financial Officers) of public listed companies based in Sweden. The final results are gained through the combination of primary data gathered from the interviews, and secondary data collected during my literature search.

My findings demonstrate that the auditors asked are in favour of audit partner rotation since according to their opinion it positively impacts audit quality because of the prevention of a too close relationship between auditor and client. Nevertheless, they do not see an additional advantage from audit firm rotation as they believe that audit partner rotation has already fulfilled the same purpose. CEOs and CFOs of public listed companies have diverse views regarding this topic. Three from five perceive auditor rotation is increasing audit quality due to the fresh look brought by a new auditor and enhanced auditor independence, while the two others think that the new regulation is reducing audit quality caused by the new auditor's lack of industry knowledge of the client. Other factors positive influencing audit quality are the separation of NAS and audit, joint-audits, expertise and experience of the auditor, a detailed audit plan, providing of full information by the client and the appointment of the auditor by the client itself.

**Keywords:** auditor rotation, audit firm rotation, EU regulation 2016, audit quality, long-term auditor-client relationship, auditing in Sweden, International Standards on Auditing (ISA), role of auditor, audit firm size, non-audit services and auditor independence.



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# 1 Introductory Chapter

The aim of chapter one is to introduce the reader to my research topic and my subject choice. Further, it provides an insight into the problem background, research gap, the research question and the purpose of the investigation. Also included in this chapter is the discussion of the limitations of the study as well as the definition of key terms used in this study. The first chapter concludes with the structure of the remaining report.

## 1.1 Subject choice

Considering that I am a business student specialised in accounting, it was clear to me to write my master thesis within this subject. As part of my program I attended a course on auditing learning about auditors' responsibilities and the need for auditing in order to ensure the reliability of financial statements serving as the basis for investment decisions. In the course of discussing audit scandals, such as the Enron case and their impact on the audit market my interest was arising to write about auditing. Those scandals show that the joint-provision of auditing and non-audit services (NAS) as well as the long-term auditor-client relationship adversely impact the auditor independence thus decreasing the auditors' ability to make an unbiased evaluation which in turn leads to a reduced audit quality. Hence, for several decades the topic of mandatory auditor rotation has been heavily discussed in order to solve these problems. As a result of my increased interest I started an extended research on this topic. During my research process, I touched on the new European Union (EU) reform requiring public interest entities (PIEs), defined as listed companies, credit institutions and insurance undertakings, to change the audit firm after 10 financial years. This regulation aims to enhance auditor independence and thus audit quality. Since this regulation is fairly new, implemented 2016, I was even more attracted by this topic of auditor rotation and its impact on audit quality. The next step was to define a research question and to decide on how to conduct this study.

## 1.2 General information

Investors' confidence is essential for the efficient functioning of the international financial markets, and adds to the economic growth and stability around the globe. They need to be sure that the financial information provided for their investment decisions is credible and reliable, which is achieved with audits and audit opinions on financial reports. The reliability of financial information created by companies, government agencies and other entities can be boosted by independent auditors who give assurance on the trustworthiness of the financial statements. Although the company's management is primarily responsible for the quality of its financial statements, external auditors give an unbiased guarantee about that quality (International Federation of Accountants [IFAC], 2010, p. 72).

To begin with, it is crucial to indicate that audit quality is perceived differently, depending who is assessing it. All parties involved in the financial report process, namely users, auditors, regulators and the society, have diverse views when it comes to the question of which influence factors play an important role for evaluating audit quality. For instance, users of financial reports consider the nonexistence of material misstatements as high audit quality, while auditors speak about high audit quality when finishing all duties required by the companies' audit methodology in a satisfactory manner. Furthermore, high-quality audit for the audit firm means that its work can be defended against challenges in an inspection or court of law. The adherence to professional standards displays high audit quality for regulators, and the society

perceives high-quality audit to be one that prevents economic problems for a firm or the market (Knechel, Krishnan, Pevzner, Shefchik & Velury, 2013, p. 386).

According to the traditional definition in the research stated by DeAngelo (1981a, p. 186), audit quality is the probability that an auditor will detect an infringement in the client's accounting system, and reports it. The detection of a breach relates to the auditor's capability and effort, whereas the report of the breach depends on the auditor's independence, objectivity and professional scepticism. Looking at the two words separately, an audit is defined as an evaluation process assessing the degree of compliance with given standards resulting in a judgement. Quality, on the other hand, is the total of characteristics and features of a process, system, and product and service able to meet concrete needs (Mills, 1989, p. 1-4). Moreover, audit quality can boost the quality of information disclosed by the companies and thus decrease information asymmetry. The information asymmetry in public markets arises from the existence of uninformed traders and informed traders. Audits are capable to decrease information asymmetry and agency costs. Further, auditors are able to discover misstatements and accounting errors in financial statements, and offer an independent assessment of the financial statements produced by the company's manager. Therefore, audit quality contributes to the trustworthiness of financial disclosure, and to that extent working with the firm is less expensive, it decreases the cost of capital (Hakim & Omri, 2010, p. 152, 153).

### 1.3 Problem background

The need for new regulatory policies, such as the mandatory auditor rotation was triggered by the collapse of Enron and some other companies, as for instance Global Crossing and the more recent scandal of Tesco, which raised concerns worldwide about auditor independence and audit quality. The scandals have proved that, particularly, the joint-provision of auditing and non-audit services as well as long-term auditor-client relationship tend to negatively influence the auditor independence (Firth, Rui & Wu, 2012, p. 110). As a consequence, this policy of mandatory rotation is recommended to enhance audit quality and thus boosting the quality of general-purpose financial statements. Further, there is evidence that mandatory rotation keeps up auditor independence, and a new view on the audit could lead to the discovery of issues that have been missed out on previous audits (Carey & Simnett, 2006, p. 653). However, the subject auditor rotation has been a well-discussed topic by academics, professionals and regulators (Forunes Dattin, 2017, p. 44). When debating the topic mandatory auditor rotation, two perspectives have arisen, the tenure and the rotation perspective. More precisely, the tenure perspective states that long audit tenure tends to harm actual and perceived auditor independence, whereas the rotation perspective is convinced that a new auditor could bring in a fresh look (Carrey & Simnett, 2006, p. 654).

As already mentioned, auditor rotation is a heavily debated topic, and thus several studies have been conducted to point out benefits and drawbacks of this new regulation. Proponents of mandatory rotation argue that it will prevent the development of a close relationship between auditor and client, and therefore ensuring auditor's independence. Another advantage of auditor rotation is that a new auditor will look differently at the accounting practices bringing a fresh view and it is likely to reduce auditor's eagerness to fulfil the client wishes (Forunes Dattin, 2017, p. 45). Moreover, under mandatory auditor rotation, auditors are more likely to resist management pressure, which leads to a more objective evaluation (Geiger & Raghunandan, 2002, p. 67). However, opponents state that due to the lack of knowledge of client practices the audit quality is likely to decline immensely. In addition, it will raise the audit expenses because of the learning curve and the restricted number of audit firms available that have the scale and

industry understanding needed to conduct a specific client engagement (Forunes Dattin, 2017, p. 45). Similarly, the Commission of Auditors Responsibilities argues that the financial statements users' advantages received through the new regulation would be offset by losing the advantages gained from a long-lasting relationship. Besides that, the new concept would not enhance audit quality or strengthen investors' confidence in audit objectivity (Brody & Moscové, 1998, p. 2).

Additionally, it is to note that different parties have diverse views regarding this topic. Investors, for example, are in favour of auditor rotation as they share the opinion that it is a helpful tool to avoid auditor conflicts of interest by reducing auditor assistance to management, and thereby bringing in a fresh look. On the contrary, the business community thinks it would lead to higher costs, lower audit quality, and possibly affects the role of the audit committee in a negative way. The US PCAOB (Public Company Accounting Oversight Board) stated that this topic is not new to public listed companies (Jenkins & Vermeer, 2013, p. 75). The policy arose at the first time in the US 1970 where the AICPA (American Institute of Certified Public Accountants) practice section mandated a regularly audit partner rotation after a period of seven financial years. Due to recent events, such as the Enron failure, the policy has been reworked with signing the Sarbanes-Oxley Act in 2002, which aims to protect investors from surreptitious accounting events through alliances approved by the US Congress in the year 2002. The Sarbanes Oxley Act (SOX Act) implemented the mandatory rotation of lead, coordinating or reviewing auditors after five years in the US 2002 (Carey & Simnett, 2006, p. 655).

However, the international policy concerning regularly auditor rotation varies immensely (Carey & Simnett, 2006, p. 655). Many jurisdictions have introduced mandatory auditor rotation, but this policy has not been adopted widely (Firth et al., 2012, p. 110). For example, in Brazil and Italy public listed companies need to change their auditors after five and nine years correspondingly (Jackson, Moldrich and Roebuck, 2008, p. 421). Looking at the UK, the department of trade and industry and the UK treasury issued a final report 2003 recommending that the audit partner should rotate every five years. Moreover, as foundation for their standards more than 80 countries have taken advantage of the International Standards on Auditing (ISA) and the code of ethics which was prepared by the International Federation of Accountants (IFAC). In the year 2001 IFAC noticed in its code of ethics that a long-lasting use of the same lead audit partner could trigger a so-called familiarity threat. Therefore, the code suggested changing the lead engagement partner after seven years and forbidding the changing partner to be the lead engagement partner until two additional years have passed by (Carey & Simnett, 2006, p. 655). In the year 2005 the European Commission (EC) required all members of the EU to use the International Standards on Auditing (ISA) (Commission of the European Communities [CEC], 2003). As said by the idea of the Swedish accounting and auditing authority (Föreningen Auktoriserade Revisorer [FAR] and Svenska Revisorsamfundet [SRS]), a member of the International Federation of Accountants (IFAC), Sweden adopted the ISAs with small adjustments in compliance with the Swedish legal and taxation requirements (IFAC, 2010, 75). In the following year 2006 the rotation of key audit partners was implemented in Europe. However, under the European Commission (EC) agreement in 2014, PIEs were required to change every 10 years their audit firm, after a maximum length of 20 years where public tendering was carried out, and up to 24 years in case of joint audits, which is an audit on a PIE by two or more auditors to produce one audit report (Forunes Dattin, 2017, p. 45).

Nevertheless, in June 2016 the European Parliament implemented a new regulation requiring PIEs to change audit firm after 10 financial years in duty. The purpose of the new regulation is

to enhance statutory audits by strengthening auditor independence, and offering high quality audited financial statements to investors and shareholders. In other words, with the help of the new reform the expectation gap existing between auditors' perceived deliverance and obligated deliverance is supposed to be reduced in order to increase the quality of audits and to regain investors' confidence in financial information necessary for future investments and economic growth (European Commission [EC], 2016). Diverse studies that have been carried out in various environments using different samples and factors offer various results concerning positive and negative connections between audit rotation and audit quality (Brody & Moscovice, 1998; Geiger & Raghunandan, 2002; Carrey & Simnett, 2006; Firth et al., 2012; Forunes Dattin, 2017).

## 1.4 Research gap

For several years it has been internationally discussed whether auditor rotation enhances audit quality or not. Due to many past events caused by the failure of long-term client-auditor tenure, such as the Enron case and Tesco, new regulations were required, and the EU-mandatory audit firm rotation seems to be the solution to the problem. However, no survey around this topic under investigation has been conducted in Sweden. Therefore, this study aims to fill the research gap by carrying out a qualitative research in Sweden in order to get a picture how professional market participants assess the impact of auditor rotation on audit quality.

## 1.5 Research question

The research question of the study is:

„ How does auditor rotation affect audit quality perceived by public listed companies and audit companies located in Sweden?“

- How does auditor rotation impact audit quality perceived by client companies?
- How does auditor rotation impact audit quality perceived by audit companies?

## 1.6 Research purpose

My study aims to figure out whether auditor rotation, with a particular emphasis on audit firm rotation, either enhances or lowers audit quality, whereby the new EU regulation will also be taken into account. Meaning to investigate whether auditor rotation improves audit quality due to a fresh view brought to the company audited by a new auditor or because of avoiding the possibility to develop an increasing sympathy between auditor and client triggering higher frauds, or if audit quality is diminished due to a new auditor's lack of knowledge of the client's industry. The intention here is to contribute to a better understanding of auditors and clients (public listed companies) concerning their attitude towards audit quality when changing the audit firm.

Further, I want to point out that I am not supporting any opinion expressed in literature around this topic. My investigation is focused on Sweden and appends the Swedish point of view based on the guidelines and standards used by auditors in Sweden to the prevailing literature.

## 1.7 Limitations

This study is exposed to several limitations. Firstly, the given research period of 10 weeks is not allowing to carry out several interviews in order to receive more meaningful and representative results. Secondly, the main focus of the research is on the Swedish market, however, also the European Union as well as the US market are to be considered. Thirdly, the sample size is categorised into two groups, audit companies and public listed companies located in Sweden. Fourthly, as the research question is about how auditor rotation impacts the audit quality perceived by audit companies and public listed companies, it needs to be considered that it is the personal view of the interviewee rather than a general fact applying to everyone. Finally, considering the research question the study mainly focuses on auditor rotation and audit quality, but the connected factors auditor independence and auditor tenure are not disregarded since they are necessary to provide a precise answer.

## 1.8 Definition of key terms and concepts

Key term	Definition
<b>Auditing</b>	“A systematic process of (1) objectivity obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria; and (2) communicating the results to interested users” (Eilifsen, Glover, Messier & Prawitt, 2014, p. 23).
<b>Auditor</b>	“An auditor is an approved or authorized accountant with the capacity to carry out audit, not to be declared bankrupt or subject to trading and consultancy prohibitions, have an education and experience required for the audit business, have passed the examination of professional competence as an approved or authorized accountant set by the Supervisory Board of Public Accountants or Supervisory Board of Authorized Accountants, and be fit and proper person to carry on audit process” (Revisorslag [SFS] 2001: 883, cited in Chia-Ah & Karlsson, 2010, p. 10).
<b>Auditor Independence</b>	“A state of objectivity of mind (in fact) and in appearance, including the absence of any significant conflicts of interest” (Eilifsen et al., 2014, p. 58).
<b>Audit Quality</b>	Audit Quality is “the market assessed joint probability that a given auditors will (1) discover a breach in a client’s accounting system, and (2) report the breach” (DeAngelo, 1981, p. 186)”.
<b>Audit Risk</b>	“The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated” (Eilifsen et al., 2014, p. 23).
<b>Auditor Rotation</b>	“Mandatory audit rotation imposes periodical breaks to audit engagements and is intended to avoid excessively long relationships between the auditor and the client” (Cameran, Negri & Pettinicchio, 2015, p. 1).
<b>Auditor Tenure</b>	“The audit firm’s (auditor’s) total duration to hold its client or number of consecutive years that the audit firm (auditor) has audited the client” (Johnson, Khurana & Reynolds, 2002, p. 640).

<b>Materiality</b>	“Misstatements, including omissions, that individually or in the aggregate could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements” (Eilifsen et al., 2014, p. 24)
<b>Misstatement</b>	“An instance where a financial assertion is not in accordance with the criteria against which it is audited (e.g. IFRSs)” (Eilifsen et al., 2014, p. 24).
<b>Non-Audit Services</b>	Are services provided by audit firms other than audits such as bookkeeping, taxation, management advisory services and human resources planning for example (Bell, Causholli & Knechel, 2015, p. 462).
<b>Objectivity</b>	“Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgement on audit matters to others” (The Institute of Internal Auditors [IIA], 2017).
<b>Professional Skepticism</b>	“An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to errors or fraud, and a critical assessment of audit evidence” (Eilifsen et al., 2014, p. 58).
<b>Reasonable Assurance</b>	“A term which implies that the engagement assurance risk is reduced to an acceptably low level in the circumstances of the engagement” (Eilifsen et al., 2014, p. 59).
<b>Risk of Material Misstatement</b>	“The pre-audit risk that the entity’s financial statements will contain a material misstatement whether caused by error or fraud” (Eilifsen et al., 2014, p. 24).

*Table 1: Definition of key terms and concepts*



## 1.9 Abbreviations

<b>AICPA</b>	American Institute of Certified Public Accountants
<b>Big 4 Accounting Firms</b>	EY, Deloitte, KPMG and PwC
<b>CEC</b>	Commission of the European Communities
<b>EC</b>	European Commission
<b>EU</b>	European Union
<b>EY</b>	Ernst and Young
<b>FAR</b>	Föreningen Auktoriserade Revisorer
<b>GAAP</b>	Generally Accepted Accounting Principles
<b>GAO</b>	General Accounting Office
<b>IESBA</b>	International Ethics Standards Board for Accountants
<b>IFAC</b>	International Federation of Accountants
<b>ISA</b>	International Standards on Auditing
<b>NAS</b>	Non-Audit Services
<b>PIEs</b>	Public Interest Entities (listed companies, credit institutions and insurance undertakings)
<b>POB</b>	Public Oversight Board
<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>PwC</b>	PriceWaterHouseCoopers
<b>SEC</b>	Section Executive Committee
<b>SOX</b>	Sarbances-Oxley Act
<b>SRS</b>	Svenska Revisorsamfundet

*Table 2: Abbreviation*

## 1.10 Chapter outline

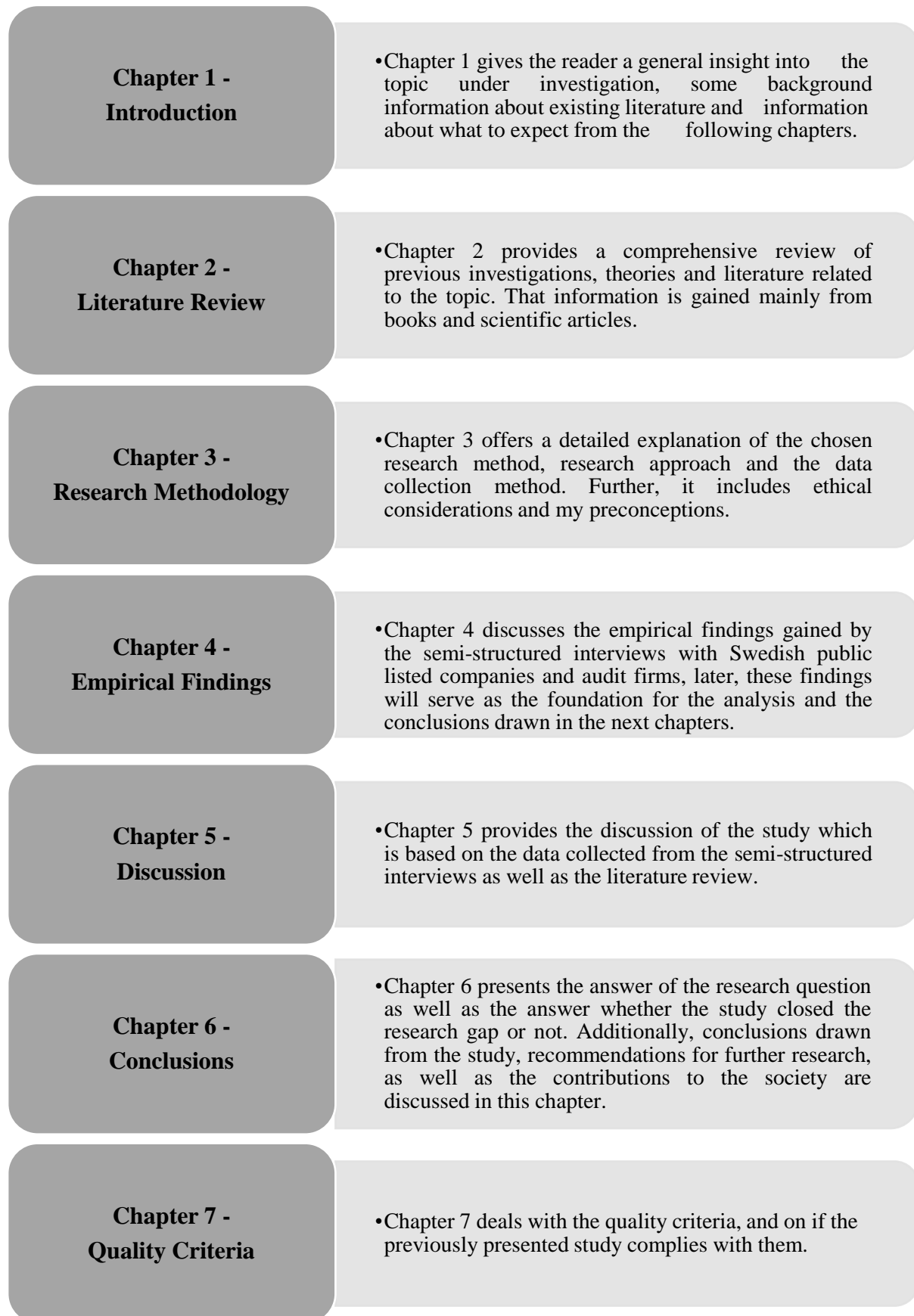


Figure 1: Chapter outline

## 2 Literature Review

The second chapter provides an insight into diverse theories connected to the present study about the effects of auditor rotation on audit quality, so that the reader becomes familiar with the existing concepts, and besides that, he or she is extending his or her knowledge by reading opinions of different authors and researchers concerning the topic under investigation. In particular, I want to emphasise that chapter two serves as foundation for my further steps. The required interview guide, analysis and conclusion build on the theories described in this chapter.

### 2.1 Auditing

A series of accounting scandals, as for example the Enron case and World Crossing, as well as a major stock market crash have marked the beginning of the twenty-first century rising the awareness that auditing plays a crucial role in the successful functioning of the financial market (DeFond & Francis, 2005, p. 5). Auditing is important as it provides assurance regarding the reliability of financial information, thereby improving resource allocation and contracting efficiency. Due to more complex business transactions and accounting standards, the ability of auditing to add value is increasing (DeFond & Zhang, 2014, p. 275). Besides that, its competence to discover expropriation helps to assert and protect investors' rights, and offers advantages to the management by providing a signalling mechanism concerning the credibility of their financial information. Furthermore, auditing contributes to the reduction of information asymmetries existing between managers and owners by ensuring that the audited financial statements were prepared in compliance with the Generally Accepted Accounting Principles (GAAP) principles (Habib, 2012, p. 214). Information asymmetry means that the manager is better informed about the company's financial position and performance than the owner (Eilifsen et al., 2014, p. 7).

The aforementioned events on the financial market have drastically changed the audit market for both auditors and clients, resulting in a strong increase in research thereby trying to recognise the drivers of audit quality as well as to a fundamental change in the supply and demand dynamics in the audit market (DeFond & Zhang, 2014, p. 275). Owing to those events, capital markets experienced a declining trust in the decision usefulness of financial accounting and auditing. Hence, the European Commission (EC) was required to bring about improvements of the professional standards of accountants and auditors (Velte, 2012, p. 81). New ways of enhancing audit quality, strengthening auditors' independence and reducing audit market concentration, especially PIEs segment, needed to be identified (Razinger-Sakel & Schoenberger, 2015, p. 61). In particular, the EC tries to avoid market concentration by forbidding the 'Big 4 only' clauses, considering that past events have left the economy with some well-known audit firms as the Big 4 (EY, Deloitte, KPMG and PwC) available to perform their audits on large companies, implying that a potential failure of one of those companies could harm investors' trust in reliability and credibility as well as adversely affect the entire financial stability (EC, 2010, p. 4). Another important provision of the new EU regulation is the implementation of mandatory auditor rotation after six years and a cooling off period of four years. It is said that external auditor rotation, meaning the change of the audit firm, is a completely fresh start, whereas internal rotation, implying audit partner rotation, only triggers changes within the audit company (Velte, 2012, p. 81).

## 2.2 Role of auditor

The statutory auditor is required to express an opinion on the correctness of the company's financial statements. Stakeholders, investors, shareholders and the public society are the parties who rely on these audits. Hence, the statutory audit plays a major role in the market functioning by enhancing credibility and efficiency of audited financial statements. Only approved auditors can perform a statutory audit (EC, 2016). According to the Directive on Statutory Audit, statutory auditors are subject to principles of professional ethics and to several principles for independence varying from behavioural aspects to considerations of ownership, fees, rotation, audit committee and firm's control system (EC, 2010, p. 10). Auditors are responsible to ensure that the financial statements are free from material misstatements and fraud, however, to assure financial reporting quality the responsibilities are far beyond the simple discovery and reporting GAAP violations. In other words, auditors aiming to provide a high audit quality are required to ensure that financial statements faithfully reflect the audited firm's underlying economics. The fact that auditors' responsibility goes beyond the simple detection of misstatements is consistent with the generally accepted auditing standards requiring auditors to assess the quality of the clients' financial reporting (DeFond & Zhang, 2014, p. 280, 281). As an example, the Auditing Standard 90 states that auditors are required to evaluate "the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting" (PCAOB, 2010). Accordingly, the auditors' task to assure financial reporting quality is corresponding with the audit opinion guaranteeing a fair presentation of the financial statements in compliance with GAAP, implying that auditors are responsible to figure out how GAAP has been applied. Further, the auditor independence standard requests the auditors, even though they are skilled in this field, to approach their clients without prejudice, if not, they do not have the needed objectivity for the trustworthiness of the results (AU Section 220-Independence) (Lu & Sivaramakrishnan, 2009, p. 72).

Additionally, it is crucial to mention that audit quality is related to the quality of the auditors' opinion concerning the assurance of the financial statements, rather than on the audit opinion itself. There is an immense variation in the quality of the auditors' opinion ranging from high to low quality. Compared to auditors providing low quality, auditors who offer high quality give a greater assurance that the financial statements represent a faithful picture of the audited companies' economic situation (DeFond & Zhang, 2014, p. 281). Considering that high audit quality enhances the credibility of financial reports, audit quality is also a component of financial reporting quality, meaning that the enhancement of the credibility gives a greater assurance that the presentation of the financial statements truly mirrors the audited company's economic position (DeFond & Zhang, 2014, p. 287). A further important aspect in view of ensuring high audit quality is, according to the EC (2010, p. 8), the consideration of the internal communication. A periodic dialogue is required to guarantee a well-functioning internal communication between audit committee, statutory auditor and internal auditors. Internal control is necessary to reduce gaps in the total coverage of compliances, risk surveillance and the substantive examination of assets, liabilities, revenues and expenses. Noting that auditors are required to provide a forecast of economic and financial information of the audited company, they should put their focus on historical as well as on future financial information (EC, 2010, p. 10).

Public listed companies are required by law to be audited, however, auditors are not obligated to assure that the clients' firm audited financial statements are completely free from material misstatements. They are committed to provide 'reasonable assurance', meaning a high level of assurance, but not the absolute assurance that the presented audited financial statements are

correct and fair and in compliance with the underlying financial reporting framework (EC, 2010, p. 6). However, the European Commission is thinking about the feasibility of a scenario where the audit role is one of statutory inspection, a third party, a regulator for example responsible for appointing the auditor, deciding on the remuneration and on the length of the engagement, rather than the audited company itself. Particularly, for large companies and systematic financial institutions this concept could be crucial for the audit of their financial statements (EC, 2010, p. 11).

## 2.3 Auditing in Sweden

Until the middle of the nineteenth century the Swedish economy mainly consisted of self-sufficient households, and only 10% of the population was dependent on trade, communications or services. With the Companies Act of 1848 new external financing opportunities were created prescribing limited responsibilities for the owners of companies. The year 1916 was characterised by a sharp increase in the number of limited company foundations. The picture of the economy changed drastically and by 1950 already 75% of the Swedish population relied on industry, trade, communications and services as a result of the speedy industrialisation. Between 1917 and 1950 up to 1250 and 2600 new limited companies were established yearly. Sweden was on a leading position among the industrialised countries in the world regarding the industrial growth between 1890 and 1950 (Wallerstedt, 2001, p. 846).

Under the Companies Act of 1895 Swedish limited companies, for the first time in history, were required to appoint one or more auditors at the annual general meeting held by the shareholders. Indeed, the selection of the auditor was based on the well-established connection between the elected auditor and the company's management or owner. Due to the fact that only some of those auditors possessed the required knowledge or expertise to conduct an audit appropriately, the number of frauds and firms' embezzlements increased significantly leading to a heavy discussion about the revisions of laws concerning the audit of companies. The Swedish Society of Auditors, namely Svenska Revisorsamfundet (SRS) was founded in 1899. Their auditors of SRS argued that the appointment of official auditors should be done by the state rather than by the company itself, but the Stockholm Chamber of Commerce came to the decision that only auditors having a qualification from Stockholm School of Economics could be authorised auditors, which represented a huge entry barrier into the audit profession. At that point in time the demand for authorised auditors exceeded the supply due to the increased number of limited companies in Sweden. Since the members of the SRS did not command over a qualification from Stockholm School of Economics, the SRS decided in 1920 to authorise their own auditors. As a consequence of heavy debates over the authorisation of auditors, Föreningen Auktoriserade Revisorer (FAR), the Swedish professional Institute of authorised and approved auditors, was founded in 1923 (Wallerstedt, 2001, p. 847-848).

Additionally, the Kreuger fraud 1932 shaped the further development of the auditing profession in Sweden. Almost ten years passed by until the audit profession in Sweden recovered from that immense damage caused by the Kreuger fraud. In order to find ways to regain trust in the auditing profession, lots of discussions, debates and committee meetings took place. The Companies Act of 1944 was the result, aiming to protect designated authorised auditors. The balance between demand and supply for qualified auditors was achieved in 1983, hence, from that time on all limited companies were required to have one authorised or approved auditor (Wallerstedt, 2001, p. 853-854).

The auditing profession in Sweden has emerged in the last 100 years. External forces like commercial interest, state authorities as well as internal forces like individuals and professional societies built the foundation for the development of the auditing profession. Nowadays, the Big 4 accounting firms, namely Ernst & Young, Deloitte, KPMG and Price Waterhouse Coopers rule the Swedish audit market but also several small and medium-sized companies (Wallerstedt, 2001, p. 863).

The Swedish Professional Institute FAR, stated that scope and objective of an audit should be to ensure the quality of companies' financial information to the market. The audit firms are required to examine the annual financial statements of the entity, the bookkeeping (audit accounts) and the management audit which means regarding its day-to-day running. Further, an annual audit report must be submitted by the audit firms reporting conclusions drawn out from their assessment. The execution of the audit engagement and any supplementary engagement carried out by a Swedish audit firm must follow the Auditing Act (1999:1079; 2001:883), any other association laws applicable and generally accepted auditing standards and professional ethics for accountancy. Besides that, companies being audited must receive information from the audit firm about any changes in the requirements significantly affecting the extent of their work. The audit firm should aim to achieve reasonable assurance that the financial statements, the consolidated financial statements and the annual accounts are free of material misstatements when planning and executing the audit. Furthermore, the audit should include the examination of evidence supporting the amounts and disclosures in the accounts, the assessment of the accounting principles applied and their use as well as the evaluation of the management's accounting estimations made when preparing the financial statements. Moreover, the company being audited has to appoint an audit firm as auditor who is responsible to choose an active auditor to conduct the audit for this firm (FAR, 2016, p. 1-2).

What is more, to ensure auditor independence, the Swedish professional Institute of authorised and approved auditors (FAR) adopted the principle based model for auditor independence leading to high audit quality when embracing it. This model is speaking of five specific threats, namely self-interest, self-review, familiarity, advocacy, intimidation, and some others, not described in detail. Firstly, the self-interest threat deals with direct or indirect financial interest in the audited entity likely to harm confidence. Secondly, the self-review threat copes with the issue how an unbiased audit can be carried out taking into consideration the auditor's ability to directly or indirectly impact the audit. Thirdly, the familiarity threat refers to the problem triggered by a close relationship between auditor and client increasing the likelihood of a biased audit opinion. Fourthly, the advocacy threat copes with the issue that the auditor acts or acted in a way to support or to oppose the view of the client on matters referring to legal or financial concerns and hence undermining confidence. Lastly, the intimidation threat covers the opportunity that the auditor is daunted due to the client's dominance or pressure. All auditors in Sweden are committed to undertake an evaluation based on the presented model to ensure that those possible threats do not adversely affect their independence when accepting new clients or assignments (SFS 2001:883). In case the auditors are not capable to preclude any of those threats and miss the required safeguards to control or eliminate them, they are forced to resign from the audit engagement. In other words, the auditors are only allowed to enter into the audit engagement or consulting assignment if no threats are identified. A documentation of the evaluation of independences in both cases acceptance and rejection of the assignment is required before the issuance of an audit report and other statements (FAR, 2016, p. 2-3).

Furthermore, as a result of the internationalisation and harmonisation of audit practices in recent years, Swedish auditors are forced to follow the international financial reporting

standards (IFRS) and the international standards on auditing (ISA) (IFAC, 2010, 72). Besides that, Swedish audit companies as well as public listed companies are required to apply the new EU regulation.

## 2.4 History of auditor rotation

Regulators, practitioners and academics have been heavily discussing for decades the topic of audit firm rotation in order to enhance audit quality. Due to mandatory audit rotation, periodical breaks are imposed to audit engagements. The aim of this regulation is to avoid long-term auditor-client relationships as it is believed that those will reduce audit quality. Further, it needs to be mentioned that mandatory rotation can either refer to the audit firm or the audit partner. More precisely, in the first case the entire audit firm must rotate after a predetermined period, whereas in the latter case only the leading partner responsible for signing the opinion must rotate after a certain period (Cameran et al., 2015, p. 1,2).

Already 35 years ago US regulators were thinking about setting up limitations on audit firm tenure because of raised concerns that a long-term relationship between auditor and client could cause a close identification of interests of both parties thereby harming auditors' independent actions. Nevertheless, the Cohen Commission advised against it due to the high costs connected with auditor rotation and the possibly lacking advantages for the users of the financial statements. Subsequently the issue of audit firm rotation became silent in the USA until late 2001 when the topic was taken up again due to the collapses of Enron, WorldCom and Global Crossing (Jenkins & Vermeer, 2013, p. 75-77). The old policy was reworked with signing the Sarbanes-Oxley Act in 2002 requiring the lead audit partner and audit review partner to change after a period of five years on public firm engagements (Carey & Simnett, 2006, p. 655). However, the US decided against audit firm rotation and was keeping up the rule of audit partner rotation (Cameran et al., 2015, p. 1). At the same time, some countries had already implemented mandatory audit firm rotation (Firth et al., 2012, p. 110). For example, mandatory audit firm rotation after a period of nine years was introduced in Italy 1975. Results of several researches about the impact of audit firm rotation in Italy have shown that changing the audit firm is quite expensive and does not improve audit quality (Cameran et al., 2015, p. 3).

Considering that changing the audit firm is associated with start-up costs, loss of client-specific knowledge, organisational disorders and the clients' ability to negotiate on audit fees, all factors influencing audit quality, the regulation has not been implemented around the globe. There is no clear picture about the application of mandatory audit firm rotation as countries around the world have taken different adjudications. Audit partner rotation has been implemented in several countries, whereas audit firm rotation has not received that much acceptance probably due to the association with higher costs. For example, the two most important regulators in the world, namely the European Commission (EC) and the PCAOB in the US chose divers paths. In the year 2006, the EU implemented mandatory audit partner rotation and more recently, in 2014 audit firm rotation, whereas the US retains as mentioned before, audit partner rotation implemented 1978 (Cameran et al., 2015, p. 2-3). Generally, it was found that most of the countries are in favour of audit partner rotation rather than audit firm rotation.

The table below gives a detailed overview about the countries applying audit partner rotation and audit firm rotation in the year 2015.

Country	Audit partner rotation	Audit firm rotation
Austria	5 years	5 years for governmental owned companies



<b>France</b>	6 years	No
<b>Germany</b>	7 years	No
<b>Italy</b>	7 years	9 years
<b>Sweden</b>	7 years	No
<b>UK</b>	5 years	10 years
<b>US</b>	5 years	No

*Table 3: Audit partner and audit firm rotation (Cameran et al., 2015, p. 6,7)*

Furthermore, in the course of discussion about the implementation of audit firm rotation, several long-term relationships have come to light. For instance, the average length of the relationship between auditors and clients of the companies in the Russell 3000 index, a weighted equity index uphold by the Russel Investment Group serving as benchmark of the whole US stock market, has been 16 years. Procter & Gambler, the consumer goods company, beats the Russell 3000 in regard to auditor tenure as the company has employed the same audit companies Deloitte & Touche LLP already for 125 years (Maxwell, 2015). Further, General Electric, one of America’s best-known conglomerates, has been in an engagement with KPMG for 106 years, and Caterpillar, the heavy equipment company, has used PwC as its audit company for 90 years. However, it is likely that there are more companies with such long relationships, but it is hard to note as only 56% of all S&P 500 companies disclosed the length of their relationships. As a result of those long-term tenures, investors were concerned about auditors’ independence and their objectivity when evaluating the financial statements. Particularly after the financial crisis they have intensified their questioning about the impact of such long relationships on auditor independence, and subsequently a new regulation such as mandatory audit firm rotation was required to reduce those lengthy relationships (Marriage, 2015).

Another big issue that triggered the need for a new policy is the domination of the Big 4 accounting firms in the present audit market. More specifically, E&Y, PwC, KPMG and Deloitte are ruling the audit market representing a challenge for smaller firms to enter the market (Fröndhoff, 2015). The concentration of supply by the Big 4 companies is likely to have negative effects on the audit market as well as on the audit quality (Francis, Michas & Seavey, 2013, p. 325). According to the EC, this concentration causes a lack of choice when selecting an audit firm (EC, 2016).

All those aspects discussed above as well as the most recent accounting scandal called Tesco in the UK, have made the need for a new regulation emphatically clear. Hence, a new reform was implemented by the European Union on 17 June 2016 requiring PIEs to change their contracted audit firm after 10 financial years (Cameran et al., 2015, p. 8). This new regulation will be discussed in detail at the end of this chapter.

## 2.5 The impact of auditor rotation and auditor-client relationship on audit quality

As already mentioned before, several past events such as the collapse of Enron and the financial crisis raised concerns worldwide about audit quality. Regulators, legislators and academics started to question the impact of a long-term auditor-client relationship on auditor independence and professional scepticism, thus triggered the need for a new regulatory policy such as mandatory audit firm rotation (Firth et al., 2012, p. 110). All in all, auditor rotation has been a well-discussed topic and several studies have been conducted to figure out the benefits



and drawbacks of this new regulation and its impact on audit quality (Forunes Dattin, 2017, p. 45).

It has been noted that arguments for and against mandatory auditor rotation are concerned with the topics audit quality, auditor independence and increasing audit costs (General Accounting Office (GAO), (2003, p. 13). In accordance with the Public Oversight Board's Panel of Audit Effectiveness (POB 200, 109), the non-existence of a close auditor-client relationship activates a real independent auditor providing high-quality audits by conducting a professional evaluation. It is maintained that the discovery and the report of substantial negative data about the client are more likely to be declared by a truly independent auditor being not impaired by a long-lasting relationship. Mandatory auditor rotation could reduce the loss of auditor independence, especially when the numbers of years are fixed (Geiger & Raghunandan, 2002, p. 69). Also, according to the SEC (Practice Section Executive Committee), mandatory auditor rotation is likely to balance out the drawbacks of lengthy auditor tenure. Firstly, it was found that long-term relationships between auditors and clients trigger the development of a close relationship where the auditors may lose professional scepticism which can cause a reduced ability to discover fraud (Brody & Moscové, 1998, p. 2; Forunes Dattin, 2017, p. 48). Secondly, auditors in a long relationship tend to view the examination just as a repetition of earlier engagements with the same client, whereby this behaviour activates auditors' tendency to anticipate results rather than giving more attention to subtle things that have changed in the clients' environment. Thirdly, regarding the SEC, auditors are more likely to overlook problems in a lengthy tenure to keep their engagement over a long period of time. This in turn leads to the situation that the auditors give priority on clients' management rather than sticking to the professional standards (Brody & Moscové, 1998, p. 2). This problem, however, could be solved under mandatory rotation where the new auditors will look differently at the accounting practices bringing a different opinion, and also the auditors' eagerness to fulfil the clients' desires is reduced (Forunes Dattin, 2017, p. 45).

Furthermore, supporters of auditor rotation share the opinion that the new regulation will motivate auditors to act independently considering they are aware that their time at this specific client company is limited and the revenues earned are for a specific time (GAO, 2003, p. 22). On the contrary, opponents argue that auditors would be exposed to immense pressure finishing the audit work of the clients within the prearranged budget. This situation could tempt them to rely mainly on audit work of previous years and thus reducing audit quality (Brody & Moscové, 1998, p. 5). In addition, they point out that both parties, audit firm and public companies, will be exposed to higher costs. The value of a regular fresh look provided by a new audit firm, in the opponents' view, may compensate for the increased risk of audit failure and the increased costs. However, supporters are convinced that the increased costs are offset by the value of the fresh look protecting shareholders and other parties relying on the financial statements (GAO, 2003, p. 13).

What is more, opponents point out that due to the lacking knowledge of clients' practices, operations and processes, the audit quality is likely to decline immensely (Forunes Dattin, 2017, p. 45). It was found that particularly in the first years of the new engagement inexperienced auditors in the new client's industry may oversee misstatements hence delivering low audit quality (Elder, Lowensohn & Reck, 2015, p. 96). Besides that, as already mentioned it will raise the audit costs for both audit firm and public company, because of the learning curve and the restricted number of audit firms available that have the scale and industry understanding needed to conduct a specific client engagement (Forunes Dattin, 2017, p. 45). These costs will involve:

- Selection costs, are the internal costs incurring for a public company when choosing a new public audit firm.
- Audit costs, are the costs incurring for the audit firm when auditing public companies' financial statements.
- Audit fee, is the amount a public firm owes the audit company when auditing its financial statements.
- Marketing costs are the costs incurring for the audit firm when acquiring and keeping audit clients.
- Support costs, are the costs incurring for the public company when explaining the company's operations, systems and financial reporting practices to the audit firm (General Accounting Office (GAO), 2003, p. 27).

Given the importance of industry knowledge and the Sarbanes-Oxley Act's auditor independence requirement, public companies can only choose between one or two real auditors under the mandatory regulation as most public companies will prefer a Big 4 company for their audit service. Nevertheless, if the market for such audits offers high profit margins more companies are likely to transform into further industry segments resulting from the mandatory audit rotation requirement. The pressure on public firm's management and auditors concerning honesty, fairness and completion of financial statements has increased in the present environment (GAO, 2003, p. 8).

What is more, an audit failure can be the result of a failure in auditor independence or audit quality negatively affecting all parties trusting the correct presentation of the financial statements in compliance with GAAP. Supporters of mandatory auditor rotation argue that the pressure on the auditors to keep their clients has developed over time close relationship with the clients' management, which in turn can negatively influence auditors' actions such as reporting issues that materially impact the clients' financial statements. On the contrary, opponents maintain that new auditors may lack knowledge about the companies' systems, financial reporting practices and information systems triggering the risk that the auditors will oversee errors in the financial reporting as they need too much time to acquire the necessary knowledge, ending that the financial statements are not in conformity with GAAP (GAO, 2003, p. 13). Nevertheless, owing to the confidence that new auditors place on the clients' estimates and representations of previous years, audit failure is more likely under mandatory rotation. Further, the accounting profession argues that under mandatory rotation auditors are not able to develop an in-depth firm specific knowledge helping them to understand the business thoroughly, thus it would not be necessary to rely fully on the management estimates (Myers, Myers & Omer, 2003, p. 780).

It is also to mention that because of the existence of a long-term annuity of potential future audit charges, audit firms will aim to please and to keep their clients as long as possible (Forunes Dattin, 2017, p. 48). Hence, auditors are tempted to take advantage of the practice of 'low balling'. More precisely, low-balling is pricing the first audit fee below the preventable costs of the new audit engagement, and then making the terms less favourable. Economically, auditors aim to keep their new engagement partners for a long period of time to offset their start-up costs with future quasi-rents. Since they are concerned about an early dismissal by the client, this practice can immensely harm auditors' independence and objectivity, thereby having adverse effects on the professional evaluation (Geiger & Raghunandan, 2002, p. 70).

To sum up, both regulations the long-term auditor-client relationship and auditor rotation have their own benefits and drawbacks. However, without rotation regulation governments with

low-quality audit firms would not have an official instrument to assess audit quality. This new policy could be able to enhance audit quality, and a huge assortment of specialised audit firms plays a huge role for improving quality. For that reason, auditor rotation could bring an advantage particularly in markets where audit specialists are present (Elder, Lowensohn & Reck, 2015, p 96).

## 2.6 The impact of audit firm size on audit quality

Several investigations have been carried out to ascertain the effects of audit firm size on audit quality. Some regulators and small firms argue that the audit firm size has no impact on the audit quality, whereas several other studies clearly notice a connection (DeAngelo, 1981, p. 183). Generally, it has been found that higher-quality audit services are provided by large firms, such as the Big 4 auditors, with international brand names rather than by small audit firms lacking industry knowledge and not commanding over a well-known brand name (Choi, Kim, Kim & Zang, 2010, p. 74). In detail, large local offices are less dependent on a specific client compared to small local offices and therefore have the power to withstand clients' influence on reporting. Since large local offices provide higher-quality audits, they are able to charge higher audit fees. This quality difference is priced as a fee premium in the audit market (Choi et al., 2010, p. 94). However, considering the famous brand name it is crucial for large companies to keep the same level of audit quality across their offices, because otherwise a poor audit quality performed by a small subsidiary office might harm the reputation of the whole audit company (Choi et al., 2010, p. 76). Besides that, DeAngelo (1981, p. 185) outlines that larger offices command over more capital and a bigger amount of resources to discover misstatements, but they are exposed to higher risk in case of an audit failure as they have more to lose.

According to Choi et al. (2010, p. 73) there are two ways to measure the office size, either by using the number of audit clients in each office or the full sum of audit fees received by each office. It was found that audit quality and audit fees have a positive association to the office size, thus supporting the assumption that large local offices deliver higher-quality audits compared to small ones, and additionally they are in the position to charge a fee premium for their quality differences (Choi et al., 2010, p. 73). What is more, the advantages gained by the office size cannot be achieved instantly, quite the contrary, a fast audit company expansion causes a temporary impairment of audit quality (Bills, Swanquist & Whited, 2016, p. 289). The growing number of new engagements and the increased workload for individual engagements are the main growth drivers of the office size. As mentioned before, larger offices deliver higher-quality audits, however, it was observed that offices, sized similarly, which have recently experienced a growth offer poor audit quality compared to those which have remained fairly stable over the present year (Bills et al., 2016, p. 290). Hence, it can be said that office size obtained in the present year negatively impacts audit quality whereas office size obtained in the former years positively impacts audit quality (Bills et al., 2016, p. 291). A reason for the poor audit quality in the year of expansion could be that offices are not prepared enough to adjust to increases in audit work (Bills et al., 2016, p. 310).

A further possible reason why larger offices provide higher audit quality is that they benefit from more in-house experience working with public companies, and they also command over more shared human capital in their office. Considering that larger offices have more engagement hours, auditors get greater chances to acquire know-how in discovering material misstatements in the financial statements of a client firm. Hence, there is a superior possibility to detect and report material problems in the financial statements when evaluated by auditors working in larger offices. Moreover, auditors of larger offices ask clients to adjust their

statements before the issuance of the report therefore positively impacting the quality of the audit report. Additionally, auditors employed in larger offices profit from a better local support network as they have several groups they can consult with. Besides that, larger offices have a stronger in-house networking compared to smaller ones, which permits higher-quality audits. However, it is to mention that in the post-Sarbanes-Oxley Act era firm-wide consultations were implemented to make it easier to offer better quality audits (Francis & Yu, 2009, p. 1523).

Summarising, it can be said that office size is one of the most crucial engagement-specific determinates of audit quality and audit pricing (Choi et al., 2010, p. 94).

## 2.7 The impact of non-audit services (NAS) on audit quality

Legislators and regulators heavily discuss the joint-provision of audit and non-audit services (NAS) as it is believed to adversely impact auditor independence and thus audit quality (Habib, 2012, p. 243). Even though several studies have been carried out on this issue, no explicit tendency concerning their impact on auditor independence could have been found (Bedard, Deis, Curtis, & Jenkins, 2008, p. 197). Evidences from research indicate that the provision of NAS offers substantial economies of scope. These are categorised into advantages of knowledge spillover and contractual economics. More precisely, knowledge spillover means the transfer of data and expertise whereas contractual economics means the better use of already developed assets when contracting and safeguarding audit quality (Habib, 2012, p. 215). Thus, audit efficiency can be enhanced with the provision of NAS (DeAngelo, 1981, p. 117). Furthermore, according to Ratzinger-Sakel & Schoenberger (2015, p. 79) audit-related and specific non-audit services are likely to enhance the actual and perceived advantages of the audit in case the independency of the auditor is adequately guaranteed. Similarly, these services contribute to reinforce the auditor's role towards the client. In addition, it was found that NAS do not jeopardise the audit quality, but are likely to negatively impact financial information quality (Hay, Knechel & Li, 2006, p. 716; Sharma & Sidhu, 2001, p. 597). Also, Dhaliwal, Gul & Tsui (2006, p. 797-798) found in their investigation that the provision of NAS adversely influences the investors' perception of the reliability of the audited financial statements. A great amount of NAS causes an increase in audit fees, thereby strengthening the economic connection between auditor and client, but investors' concerns about the independence of the auditor grow as they are worried about auditor's likelihood to bias financial reporting in favour of the client firm (Habib, 2012, p. 215). According to Eilifsen, Quick & Umlauf (2015, p. 21) the advantages gained through knowledge spillover are offset by investors' worries, leading to the investors' assumption that a high provision of NAS adversely affects auditors' independence and thus audit quality.

On the one hand, research results show that the provision of NAS is related to enhanced audit quality in the audited firm using auditors' reputational incentives and knowledge spillover and on the other hand there are investors' concerns that a great amount of NAS profits is likely to reduce audit quality. The reason for the latter one is the economic bonding through fees as well as the increased auditor self-review risk (Koh, Rajgopal & Srinivasan, 2013, p. 1; Eilifsen et al., 2015, p. 21). However, the European Parliament supranational implemented further restrictions on the provision of NAS, known as the 'black list', to audited public interest entities (PIEs) (EU, 2014). Member States have been given the option to deviate slightly from the 'black list' by either allowing specific tax and valuation services or by prohibiting even more NAS as stated on the list, whereby tax and valuation services may only be permitted if they are immaterial and do not directly impact the financial statements audited. Such services are for example the preparation of tax forms, identification of tax incentives and the provision of tax

services (Eilifsen et al., 2015, p. 10). However, according to Ratzinger-Sakel & Schoenberger (2015, p. 62), those further restrictions on NAS only partially influence the present audit market, but is likely to prevent concerns that the provision harms auditor independence and thus audit quality.

Neither the qualitative and quantitative analysis of current national regulations on the provision of non-audit services nor the incidents of the financial crisis provide clear evidence that national regulations have systematically failed to secure auditor independence. Accordingly, audit research fails to provide conclusive evidence on an impairment of both independence of mind and independence in appearance by the provision of non-audit services (Ratzinger-Sakel & Schoenberger, 2015, p. 78).

## 2.8 The connection between agency theory and audit quality

Auditing plays an important role in diminishing information asymmetry existing between managers and shareholders by ensuring the reliability of financial statements and cutting down agency problems. The agency theory represents the principal-agent conflict where the principals (owners) do not trust their agents (managers) due to information asymmetries and differing motives. More precisely, information asymmetry exists if one party has more or superior information about a topic than the other party. Furthermore, differing motives such as financial rewards, labour market opportunities, and connections with other parties which are not directly associated to principals are likely to make agents more sanguine about the economic performance of the entity or their performance under contract than it is in reality. Additionally, agents tend to be more risk averse than principals, and diverse interests may appeal agents to bias information. Information asymmetries and differing interests between agents and principals reduce the trustworthiness of information thereby triggering a loss of trust between those two parties involved. In order to solve this problem, auditors as third party are hired trying to align the interests of agents with principals and allowing principals to evaluate the agents' work and information provided, thereby upholding confidence in agents. However, in this case an auditor acts as an agent for the principal, which in turn will trigger similar issues of trust and confidence as in the manager-shareholder relationship, raising the question who is auditing the auditor. Further, this concept of auditors as agents is likely to cause a breach of trust, threats to objectivity and independence. For shareholders, the auditor's independence from the board of directors is highly important and this independence is viewed as the key to deliver high audit quality. However, an audit requires a tight relationship between the auditor and the board of directors of the audited firm. This in turn triggers shareholders to question the auditors' independence and, more importantly, the audit quality (The Institute of Chartered Accountants in England & Wales, 2005, p. 6-10).

## 2.9 The implementation of the new regulation in Europe

### 2.9.1 General information about the new reform

Due to the fact that long-term relationships between auditors and clients are likely to adversely impact auditors' independence and professional scepticism mandatory rotation has been required. However, audit partner rotation alone has not been enough as audit firms aim to keep their client as long as possible. Hence, audit firm rotation is seen as the best solution in order to avoid a close relationship between both parties involved. Further, audit firm rotation will reduce the risk of conducting repeated misstatements and will provide a fresh look, thereby enhancing professional scepticism and audit quality. To make sure a trouble-free crossover the

former auditor is required to provide an information file for the new statutory auditor (EC, 2016).

In the year 2012, mandatory audit firm rotation after twenty-five years was suggested by the European Parliament. Austria and Germany stated that a period of twenty-five years was a way too long, and it should be limited to 21 years (Ewelt-Knauer, Gold & Pott, 2012, p. 12). After many years of discussion, the revised Directive 2014/56/EU and Regulation 537/2014, a new statutory audit framework was implemented aiming to enhance audit quality by the means of strengthening auditor independence and professional scepticism (Cameran et al., 2015, p. 8). To ensure a smooth application the European Commission has cooperated closely with the European Member States. On 16 June 2014, the EU audit reform entered into force, and needed to be applied from 17 June 2016, meaning that all Member States should have placed the essential provisions to be in accordance with the new statutory framework by 17 June 2016 at the latest (EC, 2016).

Nevertheless, there are some exceptions for particular provisions, such as rotation periods as well as the 'Big 4 only' contractual clauses, which can be applied later. More precisely, rotation periods have different transitional periods, and the contractual clauses 'Big 4 only' will come into effect three years after the full implementation of the EU reform. The new regulation applies mainly for PIEs, but also non-public listed firms as far as they are subsidiaries or parent companies within a corporate group. Besides that, audits for small companies that are determined as statutory audits by national laws as well as voluntary audits carried out in compliance with national laws are also covered by the new regulatory scope, but they are not topic of this study concerning only statutory audits for PIEs (EC, 2016).

However, according to the EU reform, PIEs are required to rotate their audit firm after a period of 10 financial years. However, the Member States have been given the option to extend the engagement period. In detail, the period of the audit engagement starts from the commencement date of the first financial year the audit engagement is covered (EC, 2016). The same audit firm can be reappointed once for another period of maximum 10 years after conducting a public tendering process, and another period of maximum 14 years in case of joint audits where a public interest entity (PIE) appoints more than one audit firm to conduct its audit. After having reached the maximum length, the PIEs still have the opportunity to reappoint the audit firm for a further two years, resulting in a 10+10+2 rule in case of a single firm offers the audit service, and in a 10+14+2 rule in case of a joint audit. Besides that, it is to note that audit partner rotation period still remains seven years. Nevertheless, it is up to the Member States to reduce the period for both partner and firm rotation (Cameran et al., 2015, p. 8).

Since 17 June 2016 the new regulation has to be applied throughout Europe, but until the full implementation there are several transitional arrangements for PIEs. Firstly, if the audit engagement has already a duration of 20 or more consecutive years the engagement cannot be renewed with the acting auditor on or after the 17 June 2020. Secondly, in case the audit engagement has been in place for 11 and up to 20 years the deadline of the engagement is the 17 June 2023. Thirdly, engagements with a period of less than 11 years are allowed to keep their auditor until the maximum duration is reached. For instance, if the engagement started between the 16 June 2003 and 17 June 2006 the public listed entity is required to change or to carry out a public tendering process by 17 June 2016. Further, engagements which started after 17 June 2006 are required to rotate when the maximum duration is achieved, but there is also

the possibility to extend once after carrying out a tendering process (PricewaterhouseCoopers (PwC), 2015).

### 2.9.2 Purpose and objectives of the new regulation

As already mentioned before, the purpose of the new regulation is to enhance statutory audits by strengthening auditor independence, and offering high-quality audited financial statements to investors and shareholders. The new rules are to reduce the expectation gap existing between auditors' perceived and obligated performance. Further, the informational value of audit reports is to be improved in order to offer investors a better insight in the company and its potential. The new regulation distinguishes between audit report from non-public listed firms and public listed firms. Audit reports from PIEs have further requirements such as reporting areas of material misstatements in their financial statements and besides that, they are required to explain how far their audit is in the position to discover irregularities (EC, 2016).

To sum up, the new reform is meant to increase the quality of audits and to help regain investors' confidence in financial information necessary for future investments and economic growth. The main issues are:

- Provide investors with even more transparent financial statements.
- Strengthen independence and professional skepticism by offering auditors with a solid mandate.
- Make the European audit market more dynamic.
- Capable EU authorities are to enhance the supervision of statutory auditors and the management of audit supervision (EC, 2016).

### 2.9.3 The key elements of the new EU reform

The new framework is based on two legal instruments, the revised Directive and a new regulation. Firstly, the new Directive modifies the Directive (2006/43/EC) responsible for defining the tasks of auditors and audit firms, and requires the public supervision of auditors as well as collaboration between legal authorities in the European Union. Secondly, the new regulation has developed rules for statutory audit of public listed companies (EC, 2016).

In detail, the reform includes two measures, the horizontal and the specific. All statutory auditors and audit firms auditing non-PIEs or PIEs are required to apply horizontal measures comprising: stricter regulations on independence, providing more detailed information about the audited financial statements, enhancing the power of capable authorities responsible for the supervision of the auditors and renewing the European Commission's capability to accept the International Standards on Auditing (ISA) at EU level. Further, there are more specific additional requirements needing to be applied by the statutory auditor and audit firms of PIEs. These requirements cover the presentation of a more detailed audit report to the audit committee, including data about the audit performance, the implementation of mandatory audit firm rotation, the establishment of a list prohibiting statutory auditors and firms to offer certain non-audit services to their clients, the reduction of fees charged for non-audit services, the enhancement of the audit committee's role and the development of a conversation between statutory auditor or audit firm of the PIEs and the supervisor of that client company (EC, 2016).

Compared to other types of companies, there are stricter rules on PIEs since misstatements in financial statements of public listed companies have bigger consequences for shareholders, investors and the public society. Statutory auditors of PIEs are required to provide an additional



report to the audit committee to enhance audit quality and to reduce gaps by improving the communication between statutory auditor or audit firm and the companies' audit committee. This report will include more precise information such as the used methodology, identified lacks in the internal control system as well as the applied valuation methods. It is crucial to mention that this report is not addressed to the public, but it is up to the Member States to make the report publicly available (EC, 2016).

According to the old Directive (2006/43/EC), all public listed companies were required to establish an audit committee as part of their internal control system in order to reduce financial, operational and compliance risk and to contribute to high-quality audits. The audit committee's composition and its competences have been enhanced through the revised Directive. The new Directive has stated that the audit committee will be involved in the appointment of the statutory auditor or audit firm. Furthermore, it will also be responsible for controlling the statutory audit and the statutory auditors' independence (EC, 2016).

#### 2.9.4 The prohibition of non-audit services (NAS)

The declared goal of the new reform is that the statutory auditors and the audit firms act completely independent when performing the statutory audit being seen as their main role by the society. It happens that audit firms also offer NAS, which is likely to harm auditors' independence due to the increased risk of conflicts of interest. In order to keep the auditors' independence, the regulation established the 'black list', a list of all non-audit services forbidden to be provided by statutory auditors and audit firms to their audited companies. For instance, this list comprises services such as tax consulting and advisory services, services connected to financing, capital structure or allocation as well as any activity involving the auditor in the clients' management decision-making process. However, there are some exceptions for the Member States, meaning that they are authorised to adjust the list slightly, for example allowing audit firms to take over tax and valuation services if those services are immaterial and have no direct impact on the financial statements audited. Also, they are entitled to prohibit even more non-audit services than established in the 'black list' (EC, 2016).

Moreover, a cap of fees for non-audit services has been implemented in order to further enhance auditors' and audit firms' independence. The total limit of those fees should not exceed 70 per cent of the average fee paid in the last three consecutive financial years for the statutory audit of the audited company (EC, 2016).

#### 2.9.5 Market benefits

The present audit market is dominated by the Big 4 accounting firms, however, with the ban of the 'Big 4 only' clauses the market should be divided by more than four companies, meaning that new market opportunities appear for small companies being not members of the big networks. For instance, mandatory audit firm rotation, joint audits, public tendering and the prohibition of specific non-audit services to client firms, implying a different company is needed to carry out those services. Thus, the market will get more dynamic and the audit market will be divided by more audit companies, which in turn will reduce the Big 4 concentration. Besides that, the EU is intending to implement an additional tool to strengthen the control over the audit market (EC, 2016).



### 2.9.6 Implementation in Sweden

The Swedish Parliament adopted the EU regulation concerning audit firm rotation on 18 May 2016. On 17 June 2016, the new rules came into force, however, most of the regulations needed to be applied at first to financial year starting after 16 June 2016 (FAR, 2016, p. 1).

According to the new EU reform, all PIEs must apply audit firm rotation after a predetermined period. Listed companies which are not financial institutions, must carry out a tendering process after 10 years and then have the possibility to extend the audit engagement for another period of 10 years. Meaning after a maximum length of 20 years the companies have to change the audit firm. However, if they decide to choose another audit firm after the initial 10 years, the company has the possibility to extend the engagement for a period of 14 years (without public tendering). For financial institutions, whether listed or not, the maximum length of audit engagement is 10 years and there is no possibility to renew it. Further, if a physical person is the elected auditor of a PIE, regardless of whether listed company or financial institution, the length of the engagement is not allowed to exceed 7 years (FAR, 2016, p. 1).

There are several transitional provisions concerning audit firm rotation until the full implementation is applicable. In case the first financial year of the engagement started before 17 June 1994, the company is not allowed to enter or renew the engagement after 16 June 2020. The key date for engagements that started between 17 June 1994 and 16 June 2003 is 16 June 2023, meaning that they are no longer allowed to enter or renew the engagement after this date (FAR, 2016, p. 1).

Further, it was up to listed companies whose audit engagement started between 17 June 2003 and 16 June 2006 to decide at their annual general meeting after 17 June 2016 whether they extend the engagement or not. In case the engagement did not achieve a length of 10 years before 17 June 2016, they could decide to renew audit engagements after 10 years, conditional to tendering process or joint audit. Financial institutions have not been given the possibility of an extension (FAR, 2016, p. 2).

## 2.10 The International Standards on Auditing (ISA)

The International Standards on Auditing (ISA) cover the overall responsibilities of an independent auditor when auditing financial statements in compliance with the ISA. More precisely, they state the objectives of auditors as well as scope and nature of the audit allowing the auditors to achieve these goals. Also, scope, authority and structure of the ISA are explained and the auditors' responsibilities applicable as well as the obligation to be in accordance with the ISA when conducting an audit. The users' confidence in the financial statement is to be strengthened through an audit, which can be achieved by the auditors' opinion that the audited financial statements are free of material misstatements and in compliance with the relevant financial reporting framework. Further, the ISA do not impose responsibilities over the management or on those responsible for the governance in an entity. Besides that, the ISA do not replace law and regulations in that entity (IFAC, 2010, p. 72).

According to the ISA, the auditors are required to ensure the reasonable assurance that the audited financial statements are free of material misstatements due to fraud or error. This needs to be done before the issuance of the audit opinion. The ISA act as a supporter and help auditors to obtain the reasonable assurance in compliance with the objectives, requirements and applications created and presented in the ISA. Moreover, the auditors are obliged, throughout

the planning and performance of an audit, to exercise professional judgment and to keep professional scepticism. Further requirements are:

- the identification and evaluation of risks connected with material misstatements, either due to fraud or error, with the expertise of the entity and its environment as the foundation;
- enough audit evidence should be obtained concerning the existence of material misstatements in order to respond to the evaluated risks;
- the formation of an audit opinion about the audited financial statements with conclusions drawn from the audit evidence as a basis (IFAC, 2010, p. 73).

Besides that, auditors are requested to communicate and report the results, inside and outside the entity, to users of the financial statements. However, in case auditors are not able to obtain reasonable assurance and are unable to express a qualified opinion, they should either disclaim or rescind from the engagement, as suggested by the ISA (IFAC, 2010, p. 74). Audit evidence, containing information about accounting records in the financial statements and other information regarding the entity, is the information the auditors use to draw assumptions which build the foundation for the auditor opinion. As part of the audit, audit evidence is assessed based on its quantity and quality. In other words, quantity of audit evidence refers to sufficient audit data required essential to impact the auditors' evaluation concerning the risks of material misstatements. Quality of audit evidence offers relevant and reliable data to support the conclusions drawn for the audit opinion (IFAC, 2010, p. 75). The audit procedures performed during the audit engagement display the primary source of audit evidence. Additionally, other sources are used to obtain further information such as previous audits or the quality control procedures for client acceptance and continuance used by an entity. Besides that, also the absence of information, for example the rejection of the management to provide information, will be used as audit evidence. The major task of auditors when forming an audit opinion is obtaining and assessing audit evidence (IFAC, 2010, p. 87-88).

Audit evidence is associated with audit risk, meaning the risk that auditors express an inappropriate opinion about material misstated financial statements. This audit risk displays a function of detection risk and risk of material misstatements. More precisely, the detection risk is the risk that auditors use a procedure that is not able to discover existing misstatements which could be material on an individual basis or on the basis of a mix with other misstatements (IFAC, 2010, p. 75). Furthermore, misstatements can arise through fraud or error. The risk of material misstatements comprises two components, namely the inherent risk and the control risk. The inherent risk is related to the susceptibility of an assertion in the financial statements regarding account balance, class transaction or disclosure of material misstatements either individual or in combination with other material misstatements before other controls are considered. The control risk, on the other hand, is related to the risk that an existing material misstatement in an assertion about an account balance, class transaction or disclosure either individual or in combination with other material misstatements cannot be prevented, discovered or modified in a timely manner by the internal control of the entity. Further, professional judgement required from the auditor when conducting and performing the audit, is the application of necessary training, knowledge and experiences within the context of auditing, accounting and ethical standards in order to make appropriate decision concerning the courses of action that are suitable in the circumstances of the audit engagement. Professional scepticism, on the other hand, is related to the auditors' attitude having a questioning mind, being attentive to conditions that are likely to indicate a possible material

misstatement either due fraud or error, and a critical evaluation of audit evidence (IFAC, 2010, p. 76-77).

Pursuant to the ISA, auditors are required to act in accordance with ethical requirements like independence, integrity, objectivity, professional competence and due care, confidentiality and professional behaviour as specified by the International Ethics Standards Board for Accountants (IESBA) referring to financial statement audit engagements. Independence includes independence in mind and independence in appearance according to the IESBA code. Auditors' independence from the client is likely to safeguard their capabilities to create an audit opinion thereby not being adversely influenced by any factors that could jeopardize that opinion. In addition, auditors' independence leads to an enhancement of their ability to operate with integrity, to stay objective and to keep an attitude of professional scepticism (IFAC, 2010, p. 84). However, the auditors are required to conduct the audit in compliance with the ISA and the auditing standards of the particular jurisdiction or country (IFAC, 2010, p. 94).

### 3 Research Methodology

In this chapter, I will discuss my philosophical point of view where I will explain my ontological and epistemological position. After that, I will move on to my research approach and design in order to give a picture about the way my research was carried out from a philosophical viewpoint. Then, my research strategy, sample selection, literature search, data collection and analysis as well as my choice of literature will be presented. Finally, I will discuss ethical considerations.

#### 3.1 Preconceptions

When carrying out research the researcher needs to be conscious about her or his pre-understanding about the topic of investigation (Saunders, Lewis & Thornhill, 2009, p. 151). More precisely, according to Bickman & Rog (1998, p. 77), a preconception is what the researcher believes happens regarding the research subject. Furthermore, preconceptions reveal researcher's beliefs and motivations, which is crucial since they give the direction how the researcher will conduct her or his study. For example, the way how she or he will approach the research problem, is finding related literature and how she or he is planning to solve the problem. Researcher's previous experiences also count to the preconceptions which have an impact on the way how the researcher intends to evaluate her or his findings (Malterud, 2001, p. 484). From this I conclude that it is important to pay attention of her or his preconceptions as they have a significant influence on the way the investigation is carried out.

Under the influence of my business studies at Umea University I had preconceptions pertaining to the theories employed in my theoretical framework. Last semester I took part in a course of auditing learning about diverse impacts on audit quality, such as audit size and non-audit services, meaning that I have already acquired knowledge about this subject. Moreover, watching the news and reading articles in diverse newspapers helped me to find my topic of interest. Nevertheless, one could argue that previous knowledge and preconceptions adversely affect my research. Hence, I tried to gather as much new information as possible. Previous knowledge and preconceptions merely served as helping tool for deciding on my research topic.

#### 3.2 Ontology

Ontology deals with the nature of reality (Saunders et al., 2009, p. 110; Collis & Hussey, 2014, p. 47). The definition of ontology provided by Bryman & Bell (2011, p. 32) is more distinct, ontology relates to the question concerning social entities, nature and art, whether they should be viewed as objective entities or as constructive entities, depending on the perceptions and actions of different actors. There are two main ontological positions that can be applied, namely objectivism and constructionism (subjectivism). The difference between these two positions can be demonstrated by reference to organisation and culture (Bryman et al., 2011, p. 32). In other words, objectivism proposes that the existence of social phenomena is beyond the influence of social actors, hence social entities are external to social actors (Saunders et al., 2009, p. 110). Only one reality exists and everybody shares the same sense of reality, considering the social reality is objective and independent to the researcher (Collis & Hussey, 2014, p. 47). Constructionism (subjectivism), on the other hand, suggests that the occurrence of social phenomena is not only because of social interaction, but they are revised constantly (Bryman et al., 2011, p. 37). Hence, according to Collis & Hussey (2014, p. 47) the social reality is subjective as it is socially constructed, meaning that every single person has her or his own sense of reality and thus there is more than one reality.

I embrace constructivism as my ontological position since I assume that diverse firms perceive the impact of auditor rotation on audit quality differently. Saunders et al. (2009, p. 111) argue that constructivism tries to understand the meaning individuals give to social phenomena. The reality is socially constructed as subjectivism is often attached to social constructionism. Looking at my study, all different actors such as auditors, CEOs or CFOs, having diverse positions and experiences, had a different view on the impact of auditor rotation on audit quality. The way how they perceive the impact depends on their view of reality (Collis & Hussey, 2014, p. 47). Therefore, I made a great effort to understand the subjective reality of my different interview partners when selecting and interviewing them. My research question was derived from my ontological view, aiming to gain a deeper understanding on how audit firms and public listed firms perceive the impact of auditor rotation on audit quality. Hence, the objectivism position would not have fitted in to my context as objectivism believes that the social reality is objective and everyone shares the same sense of reality, which is not the case in my study (Saunders et al., 2009, p. 110).

### 3.3 Epistemology

Epistemology concerns with what is considered as acceptable and appropriate knowledge in a specific field of study (Saunders et al., 2009, p.112-113; Collis & Hussey, 2014, p. 47). Bryman & Bell (2011, p. 26) state that a particular issue in this context is the question whether the principles and methods applied in the context of natural sciences should be or could be the basis for the social world. Accordingly, it can be distinguished between three main positions within the epistemological assumption, positivism, interpretivism and realism (Saunders et al., 2009, p. 113-115). Firstly, positivism refers to the belief that only observable and measurable phenomena can be warranted as knowledge. The social reality is objective and independent of the researcher (Collis & Hussey, 2014, p. 47). Further, hypotheses are generated to be tested, and are approached by the researcher on a value-free basis (Bryman & Bell, 2011, p. 28). Secondly, interpretivism takes into consideration the existence of differences between humans as social actors and the necessity to study humans within their own social boundaries (Bryman & Bell, 2011, p. 29) Moreover, the social reality is subjective, multiple and socially constructed (Collis & Hussey, 2014, p. 47). In addition, the knowledge arising from subjective understanding and meaning of social phenomena depends on the participants' perceptions, and is considered as valid knowledge under the interpretivism position (Collis & Hussey, 2014, p. 45). Thirdly, realism, similar to positivism, recommends methods of natural and social science, and believes that the researcher should concentrate on external reality (Bryman & Bell, 2011, p. 29). The objective reality can be interpreted in diverse ways as realism believes that our senses specify reality (Saunders et al., 2009, p. 114).

In my study, I intended to figure out how audit firms and public listed companies based in Sweden perceive the impact of auditor rotation on audit quality. Considering this, I was looking for a subjective view rather than the objective truths, because I would not have received the required knowledge and understanding by using positivistic methods. Given that, I chose the interpretivism as my epistemological position. The research in interpretivism provides an interpretive understanding of social phenomena usually specified in a particular context of the phenomena (Collis & Hussey, 2014, p. 44-45). Thus, interpretivism was matching with my intention to carry out a more comprehensive research by capturing perspectives from auditors and employees working in a public listed company. Further, it was my goal to understand and interpret the interaction between the different participants from their perspectives, so this is a further confirmation that my study is framed by the interpretive position (Saunders et al., 2009, p. 116).

### 3.4 Research approach

It can be distinguished between three different approaches when conducting research: deduction, induction, and abduction (Saunders, Lewis & Thornhill, 2012, p. 143-145). More precisely, the deductive approach describes an investigation developing a conceptual and theoretical structure which afterwards will be tested by empirical observation, thereby deriving specific instances from general conclusions (Collis & Hussey, 2014, p. 7). A deductive approach consists of several successive steps, starting with creating hypotheses, using existing theories to derive conclusions, examining if the newly created hypothesis will contribute to our general understanding. Subsequently, data can be collected helping to decide to either reject or confirm the new hypotheses (Blaikie, 2009, p. 85). This approach is mostly used in studies which conduct quantitative research, explicitly formulated hypotheses are either confirmed or rejected (Collis & Hussey, 2014, p. 7).

Secondly, the inductive research is a study that develops a theory based on observation of empirical reality, thereby inducing wide-ranging conclusions from specific examples (Collis & Hussey, 2014, p. 7). According to Saunders et al. (2012, p. 145) the inductive approach is defined as “collecting data to explore a phenomenon and to generate or build theory”. The aim of the inductive approach is to develop limited generalisations about observation of human beings and social phenomena. Through the discovery of patterns and characteristics a generalisation should be made (Blaikie, 2009, p. 83). The inductive approach is mainly used in qualitative research deriving general conclusions from observation (Collis & Hussey, 2014, p. 7).

Thirdly, the abductive approach is defined as “collecting data to explore a phenomenon, identify themes and explain patterns to generate a new or modify theory which you subsequently test through additional data collection” according to Saunders et al. (2012, p. 145). The abductive approach is a combination of deductive and inductive approach. Further, when conducting research using the deductive approach, the research starts by observing a ‘surprising fact’ and then discovers the reason for the existence of this fact (Saunders et al., 2012, p. 147).

In my study, I embrace the deductive research approach since my research question aims to create new knowledge while taking advantage of existing theories. Prevailing literature also served as foundation for the formulation of my research question as well as for the development of the theoretical framework which built the basis for my interview guide (Blaikie, 2009, p. 85). Besides that, the deductive approach enables a quicker actuation, thus it seemed to be the most suitable approach for my study, especially considering the short-time frame (Saunders et al., 2012, p. 127). Without investigating prior studies, it would have been quite challenging to carry out this study. Consequently, using the inductive approach instead would have led to difficulties when creating the interview guide as it is time-consuming and demanding to come up with questions without having studied previous theories and only focusing on reality. Given the fact that I intended to explore the effects of auditor rotation on audit quality perceived by audit firms and public listed companies located in Sweden the deductive approach was the most suitable one in my opinion as it increased my possibility to obtain a better understanding of the problem by studying existing literature related to my topic. Further, through the data gained from the interviews I received the opportunity to extend my theoretical knowledge, because I got useful hints for additional theories which were not included in the framework about my topic, so I could add up new findings.



### 3.5 Research design

The research design is related to the researcher's choices concerning methodology and methods that will address the research question (Collis & Hussey, 2014, p. 59). According to Bryman & Bell (2011, p. 49) a research design offers a framework for analysing and collecting information. Considering that the research paradigm is a philosophical framework serving as a guide for how research is supposed to be carried out, the paradigm, interpretivism in this study is closely connected to the research design (Collis & Hussey, 2014, p. 59). It can be distinguished between five different research designs, namely experimental, cross-sectional, case study, longitudinal and comparative (Bryman & Bell, 2007, p. 45).

In my study, I used the cross-sectional design which is defined as “the design that entails the collection of data on more than one case (usually quite a lot more than one) and at a single point in time in order to collect a body of quantitative or quantifiable data in connection with two or more variables (usually many more than two), which are then examined to detect patterns of association” (Bryman & Bell, 2011, p. 62). The reason for the selection of this specific research design was that I tried to find out whether auditor rotation impacts the audit quality perceived by audit firms and public listed companies in a positive or negative way. Hence, I took diverse audit firms as well as client firms into consideration in order to receive different perceptions regarding my research topic. Since it was necessary to investigate several cases, I conducted semi-structured interviews with different companies at a specific date and time, whereby the variations between these cases helped me to gain more data. Given the fact that the data collection of all cases should be done at a single point in time, the interviewees were required to reply promptly to the questions asked during the interview, and their feedback was collected immediately. The gained data delivered useful results helping me to answer my research question. In order to meet the mandatory requirements of the design, I took a representative sample from the overall population. To sum up, the cross-sectional design was the most suitable one for my study, because all criteria required were given.

### 3.6 Research method

According to Creswell (2014, p. 4), there exist three main research strategies, namely qualitative research, quantitative research and mixed-methods research. The qualitative research aims to gain a deeper understanding of people's ideas and attitudes triggering their actions, whereas the quantitative research aims to test theories by investigating the relationship among various variables expressed in numbers and usually analysed with the help of statistical methods. Lastly, mixed-methods are a combination of qualitative and quantitative research (Creswell, 2014, p. 4).

In my study, I applied the qualitative research strategy by conducting interviews in order to collect required data. Interviews are carried out to collect primary data from selected respondents to find how they think, feel and do (Collis & Hussey, p. 133). I used semi-structured interviews, meaning interviews with a list of predetermined questions created by the interviewer beforehand, serving as a guide during the interview (Longhurst, 2003, p. 118). The order in which the questions were asked was flexible and could be changed depending on the situation during the interview. Besides that, further questions could be added during the interview reliant on the interviewee's answer (Collis & Hussey, 2014, p. 133-134). Furthermore, my interview guide consisted of open-ended and closed questions. In particular, open-ended questions cannot be answered with 'yes' or 'no', they demand for a longer and more detailed reply, whereas for closed questions a simple 'yes' or 'no' is enough (Collis &

Hussey, 2014, p. 133). The basis for my interview questions was my theoretical framework. In order to give the interviewees an idea what the study is about an email were sent to them with some key facts about the study as well as short information about myself and my research plans. This email can be found in the Appendix 3. To make it more convenient for the interviewees they could chose date and time for the interview within a given time frame, from 1 May 2017 to 17 May 2017, also stated in the email. The average length of an interview was approximately 15-30 minutes. Furthermore, I divided my interview questions in two parts. The first part consisted of questions regarding their company and general questions about the topic under investigation, whereas the second part included more precise questions about auditor rotation and its impact on audit quality. Also, the interview guide for both parties, audit companies and public listed companies, can be found in Appendix 1 and 2. My interviews were conducted by telephone as I carried them out with firms across Sweden. Also, ethical issues were taken into account and all interviewees were asked whether their name can be mentioned in the thesis or not. Eight out of seven requested to keep their data confidential, hence neither the name of the interviewee nor the name of the company is published in my thesis. At the beginning of each interview the respondents gave verbally their agreement to record the conversation.

However, there are various reasons why I chose semi-structured interviews carried out by telephone. Firstly, I aimed to gain a deeper understanding about the impact of auditor rotation on audit quality perceived by audit firms and public listed companies. Hence, the focus was on words rather than on numbers as it is in quantitative studies. Secondly, I intended to understand and interpret the interviewees' experiences and patterns regarding the topic under investigation, thus the qualitative study was the most suitable one for my investigation. Thirdly, owing to the fact that my study was conducted with companies across Sweden, I decided to carry out telephone interviews to save time and money. According to Collis & Hussey (2014, p. 134) telephone interviews are a commonly used method as it decreases the travel expenses and there is still the opportunity to be in personal contact. However, one drawback of this type of interview is that it cannot be as long as a face-to-face interview could be. Besides that, more equipment is required to record the conversation and the expenses for the call should also be taken into account (Collis & Hussey, 2014, p. 134). Nevertheless, this was the most suitable option for my study since it had fewer constraints concerning the geographical location. If I had chosen the quantitative method which focuses on numbers and statistical evaluation, I would have lost flexibility, which is given in the qualitative research, and I therefore believe that my selection was appropriate in regard to my topic.

### 3.7 Sample selection

According to Collis & Hussey (2014, p. 131), a subset of the entire population is a sample where the population can be either people or items selected for statistical investigations. Saunders et al. (2009, p. 213) distinguish between two sampling methods, namely the probability sampling and the non-probability sampling method. In the first one each member of the sample has the equal chance of being chosen, hence the generalisation of the findings is possible as it tends to exactly reflect the whole population. Conversely, the second one does not use a random selection method, thus only a subset of the population is more likely to be included (Bryman & Bell, 2011, p. 176). Moreover, probability sampling methods are common in quantitative studies, whereas non-probability sampling methods are used in qualitative studies. Considering that my study is qualitative, I had the choice between three forms of non-probability sampling, namely snowball sampling, judgemental sampling and convenience sampling. In detail, snowball sampling involves experienced people in the field of investigation



and further asks them to get introduced to other experts in order to extend the sample. The judgemental (purposive) sampling only includes experts in this field, whereas the convenience (natural) sampling involves people available and does not impact the sample structure (Collis & Hussey, 2014, p. 132).

In my study, I intended to investigate what influence auditor rotation, especially audit firm rotation has on audit quality as it is perceived by audit firms and public listed companies located in Sweden, with a particular focus on the new EU audit reform. Taking into account that the new EU regulation mainly affects PIEs, it was strictly necessary to approach public listed companies and audit firms conducting the audits for public listed companies. It was my goal to undertake four interviews with audit firms and four with public listed firms as an equal number of both types of companies is a good basis for the comparison of their views referring to the topic under investigation. In order to achieve my desired sample, I used the judgemental (purposive) sampling method with the purpose to select a sample from audit firms, trying to address experts in this field, whereas for the sample of public listed firms I selected the convenience (natural) sampling method by contacting listed companies published on the NASDAG website. The reason for my sampling method choice was that I had specific audit firms in mind, namely the Big 4 offices located in Sweden, thereby the judgemental (purposive) sampling method seemed to be the most suitable one, whereas for my choice of public listed firms I selected the convenience (natural) sampling method, considering that I am not from Sweden, not familiar with specific companies based here I took advantage of the NASDAG website. I started to get in touch with the Big 4 accounting firms to arrange interviews with their auditors responsible for public listed firms. After that, I approached public listed companies based in Sweden and carried out interviews with their CEOs and CFOs. In fact, I carried out five interviews with CEOs and CFOs of public listed companies and three with auditors employed in a Big 4 offices.

### 3.8 Literature search and data collection

According to Collis & Hussey (2014, p. 76), the literature search is a systematic process aiming to identify previous research related to the topic under investigation. Moreover, existing literature helps to identify key issues or topics, data collection for example, thus helping to design the methodology (Collis & Hussey, 2014, p. 76). In my literature review, I tried to explore the subject as a whole by pointing out different opinions rather than just searching for literature that matches best with my research topic. Moreover, I aimed to use primary sources as well as secondary sources. Primary data are data gained from an original source such as interviews or focus groups, whereas secondary data are data gathered from existing sources like databases or publications either available on the Internet or as a hard copy (Collis & Hussey, 2014, p. 59).

#### 3.8.1 Secondary data

I started with the collection of secondary data in order to deepen my knowledge regarding my topic. It is quite challenging to find suitable secondary sources for your research. I mainly used articles downloaded from the database EBSOC which is a specific online research database provided by Umea University or Google Scholar. Also, I took advantage of the Umea University library search engine where I could find suitable journals and articles. Besides that, hard copy books and journals offered by Umea University library were beneficial for my study. Additionally, I used the internet to find diverse sources such as newspapers which could be advantageous for my research. In the beginning, I looked for simple keywords which are related

to my topic, however, I experienced the literature search as a learning process and became better over time in finding suitable words. What is more, as the time went by I understood how helpful it is to review the reference lists of journals and articles in order to find additional literature which is essential for your topic.

**Keywords:** auditor rotation, audit firm rotation, EU regulation 2016, audit quality, long-term auditor-client relationship, auditing in Sweden, International Standards on Auditing (ISA), role of auditor, audit firm size, non-audit services and auditor independence.

### 3.8.2 Criticism secondary data

After having selected articles and journals, a critical evaluation was necessary to decide on whether they are relevant and significant for my study or not. In order to prevent criticism about my use of articles including different opinions from several researchers, I studied a number of articles to find a research gap and to gain an extended perspective. Therefore, I chose solely such articles and journals which were relevant to my research topic, but in the course of time I could not gain any new information, quite the contrary, I achieved theoretical saturation.

Although I believe that the theoretical framework of my Master thesis should mainly focus on scientific articles, I also had to deal with auditors' responsibilities determined by laws and other regulations. Thus, my thesis is a combination out of theories, scientific articles, laws and regulations.

### 3.8.3 Primary data

In order to gather primary data, I conducted semi-structured interviews with some of the Big 4 accounting firms and public listed firms across Sweden. As already mentioned before, in this type of interview the researcher prepares the questions prior the interview, however, the order in which the questions are asked is flexible and can be changed depending on the situation in the course of the interview. Besides that, further questions can be added during the interview reliant on the interviewee's answer (Collis & Hussey, 2014, p. 134). In particular, I carried out five interviews with public listed firms in various branches such as manufactory, pharmacy, gaming and oil as well as three with audit firms. As already mentioned in the research strategy, the interviews were conducted by telephone to save time and money. However, the detailed reasons for my selection have already been discussed in the research method section.

## 3.9 Data analysis

In order to analyse the gained data, it is necessary to distinguish between several techniques, namely the content analysis, the thematic analysis and the general analytical procedure. Firstly, the content analysis is a method converting chosen items of qualitative data to numerical data for analysis, Secondly, the thematic analysis categorises the themes in the relevant literature. Thirdly, the general analytical procedure is a method converting rough field notes into a written record. In the analytical procedures, there are three steps that have to be considered, namely data reduction, data presentation and conclusions. Further, it needs to be examined whether the findings are valid (Collis & Hussey, 2014, p. 88-89).

When analysing my data gathered through the interviews, I took advantage of the general analytical procedure. With the approval of all interviewees I recorded the interviews and transcribed those straight after the interview to ensure that there are no misinterpretations and that they are easily accessible. Thereafter I started to categorise the answers of all interviews

according to my interview questions which were grouped with regards to different themes such as general questions about the topic and impact of auditor rotation on audit quality. Thus, I composed a little summary for each section. After that I was ready to draw my general conclusions which can be found in the final section of my thesis.

### 3.10 Choice of literature

The literature review serves as introduction, the reader is given an insight of the research that has already been conducted on this subject (Saunders et al., 2012, p. 603). For my study, I used the deductive approach, therefore it was crucial and helpful to review existing literature related to my topic in order to deepen my knowledge and to become able to solve my research problem. Since my research is about auditor rotation, audit quality and auditor independence requirements, I decided to use the standards and regulations ruling those issues to give the reader an overview about the legal framework of the research topic. These provisions are the Companies Act, International Federation of Accountants (IFAC), International Standards on Auditing (ISA) and several other EU regulations. Considering that the study deals with companies based in Sweden, I further added FAR in my literature review. Furthermore, I gave a precise description about auditing and the role of the auditor as defined in the Companies Act and ISAs in order to help the reader to understand the basics connected with my topic. Moreover, I provided detailed information about the new EU reform where I highlighted the main changes in the audit environment to make it easy to retrace them. Given the fact that audit quality is a wide-ranging topic, I tried to find the most commonly used definitions to deepen the readers' comprehension about it. Besides that, I included the agency theory, and explained the auditor's mediating role between shareholders and management. In addition to the laws and theories I involved articles in which the problem area is dealt with in a similar way.

### 3.11 Ethical considerations

When carrying out business research the researcher will face several ethical issues which need to be considered to act in an ethical manner (Saunders et al., 2009, p. 183). Collis & Hussey (2014, p. 30) state that research ethics "is concerned with the manner in which research is conducted and how the results and findings are reported". The code of conduct standards including moral values, procedures and principles form the base for ethical considerations (Collis & Hussey, 2014, p. 30). In accordance with Saunders et al. (2009, p. 187), the interaction between researcher, research user and respondent triggers the occurrence of ethical issues. These ethical issues can arise at all stages of the research such as during the formulation of the research subject, during the data collection process, during the data analysis or the reportage of the results (Saunders et al, 2009, p. 188). In order to offer a high-quality research, I made a great effort on taking into account these issues.

Bryman & Bell (2011, p. 128) expounded four main ethical principles that need to be considered when carrying out research. In particular these comprised "harm to participants; lack of informed consent, invasion of privacy; involvement of deception". Firstly, the researcher should ensure the wellbeing of the participants, physical and psychological, hence not causing any harm to them (Collis & Hussey, 2014, p. 31). In order to make sure that I do not cause any harm to my interviewees I used semi-structured interviews, thus questions could be changed and adjusted during the interview, which in turn helped to avoid an ethical dilemma. Secondly, it is also important that the research participants are completely informed about the research subject and receive appropriate and enough information prior the research (Collis & Hussey, 2014, p. 31). Considering this, my interviewees received a short explanation about my

research study prior the interview as well as information about myself. Besides that, I kindly asked them if they are willing to participate and if their expressed opinion about the topic can be used for the purpose of my research. Thirdly, privacy refers to the necessity to accept and do not enter in the participants' privacy (Collis & Hussey, 2014, p. 31). To ensure that I do not enter their privacy I assured them that despite recording our conversation would not be published, and an identification of their statements would not be possible in my thesis. Additionally, I demanded their approval for recording our conversation. According to Collis & Hussey (2014, p. 32-33), the assurance of anonymity and confidentiality triggers the feeling of liberty and thus interviewees are more willing to talk about their feelings. Lastly, the researcher should not mislead the participant during the research process neither through lies nor through deceptive conduct (Collis & Hussey, 2014, p. 32). When undertaking my interviews, I was honest and ensured transparency of all given information. Further, I did not intend to manipulate my interviewees, and to safeguard that the presentation of my interviewees' statements are true I recorded and transcribed all conversations with them. Hence, I believe that my work thoroughly pays attention to all ethical issues that need to be reflected when conducting a research.

## 4 Empirical Findings

Chapter four starts with a short presentation of all interviewees who took part in the research in order to provide the reader a precise description of the study participants. Then the detailed findings gained from the semi-structured interviews are presented accurately. These findings are divided into two main parts, responses from employees of public listed companies and responses from auditors working in an audit company. Each part will conclude with a little summary of the key findings collected by the qualitative study.

### 4.1 Details about the interviewees

#### 4.1.1 Respondents of public listed companies

As already mentioned in chapter three, I carried out five semi-structured telephone interviews with male CEOs and CFOs of public listed companies based in Sweden. The complete interview guide can be found in Appendix 1. All interviewees requested to keep their data confidential, thus I will neither mention a company name nor the name of an interviewee.

The table below provides detailed information about the interviewee, the company's industry, date and duration of the interview. Besides that, the type of the interview is stated.

Interviewee	Industry	Date	Duration	Type of interview
<b>CFO of Company 1</b>	Pharmaceutical Industry	5 May 2017	22:06 mins	Telephone
<b>CEO of Company 2</b>	Gaming Industry	8 May 2017	17:23 mins	Telephone
<b>CEO of Company 3</b>	Pharmaceutical Industry	8 May 2017	16:42 mins	Telephone
<b>CFO of Company 4</b>	Oil Industry	10 May 2017	26:11 mins	Telephone
<b>CEO of Company 5</b>	Manufacturing Industry	17 May 2017	19:25 mins	Telephone

*Table 4: Respondents of public listed companies*

The second group of my respondents consisted of three auditors, two males and one female, working in a Swedish based audit company. The complete interview guide can be found in Appendix 2. Two out of three interviewees requested to keep their data confidential hence I will neither mention their name nor the name of the company. However, Eva Melzig, an authorised auditor working at KPMG which is one of the Big 4 accounting firms, agreed with mentioning her details in my study.

The table below provides precise information about the interviews conducted with audit companies based in Sweden. The exact date and duration of each interview are stated as well as the type of the interview.

Interviewee	Date	Duration	Type of Interview
<b>Auditor of Company X</b>	11 May 2017	32:01 mins	Telephone
<b>Auditor of Company Y</b>	15 May 2017	25:33 mins	Telephone

<b>Eva Melzig, auditor of KPMG</b>	16 May 2017	27:20 mins	Telephone
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Table 5: Respondents of audit companies

## 4.2 Part one – Interviews with public listed firms

As a simplification and for a better understanding in the following section, I assume that interviewee 1 belongs to company 1, interviewee 2 belongs to company 2 and so on.

### 4.2.1 Auditing and role of auditor

#### 4.2.1.1 Present auditor-client relationship

At the beginning of each interview I asked when they have engaged their present auditor, and I noticed that the majority of the interviewees have just engaged their auditors, speaking of a period from two to three years, apart from interviewee 2 who appointed his one in the year 2010. Furthermore, three from five respondents said that they have already changed their auditor because of the demand for better quality. Interviewee 2 told me that the reasons for his change were *“at the one hand the combination of costs, quality and knowing the business is important to me, but my previous auditor did not fulfil my requirements and on the other hand I had to change the auditor because of the existing EU law where we must change the auditor after a period of seven years”*. Interviewee 4 and 5 argued that their auditors were only focused on the detection of material misstatements and on checking whether their financial statements are in compliance with GAAP, but did not pay any attention to the quality of them. None of the interviewed public listed companies has a policy for changing auditor apart from the already existing EU regulation requiring public listed companies to change their audit partner after a period of seven financial years.

#### 4.2.1.2 The importance of audit quality when deciding on auditor

Generally, I figured out that the audit quality plays a crucial role when it comes to deciding on an auditor and everyone perceives it differently. I received various answers, interviewee 1 and 2 share the opinion that good audit quality is crucial in combination with costs, and interviewee 3 said *“I need an auditor who is doing his job appropriately and is able to cooperate and knows the business, company and strategy”*. Interviewee 4 believes that audit quality is hard to measure and in his opinion a good auditor should be creative and able to find solutions to the problem, and interviewee 5 argued *“a good auditor finds material misstatements and helps the company to improve their financial statements, therefore in my opinion audit quality is super important”*. Moreover, I found that the majority of my interviewees is satisfied with the audit quality of their present auditor, interviewee 3 said *“very happy with it – very strict and organised, he understands the company and gives lots of advice”*, however, interviewee 4 displays an exception and is not really satisfied as he believes his auditor is a more problem-oriented one rather than focusing on solving the problems.

#### 4.2.1.3 Main areas of audit opinion received

When asking what are the main areas of audit opinion they receive, areas such as tangible assets, risk assessment, bad debts, reconciliation, acquisitions, tax issues and accounting principles were mainly mentioned. Surprisingly, none of the interviewees had to report a material misstatement within the past 5 years.



#### 4.2.1.4 The appointment of an auditor through a regulator

Furthermore, I also asked for their opinion about the idea of the European Commission that the appointment of an auditor should be done through a regulator rather than by the client firm itself. The majority of the interviewees argued that this is a bad idea as it will increase costs and the selection of an auditor for a public listed company will be purely random. For instance, interviewee 1 said *“bad idea, why should somebody else decide on your auditor – he does not know the company, you use your auditor for other things as well, as a consultant for example – you need to trust your auditor”*, whereas interviewee 4 expressed a contrary view *“it’s positive it’s a weird relationship as it is now – auditor is the client of the company so he or she is not independent – will always be affected by the company’s board and management – the auditor should be more independent”*.

#### 4.2.2 The impact of auditor rotation on audit quality

##### 4.2.2.1 Perceived impact on auditor’s independence and objectivity

Raising the question how the independence and objectivity will be affected through rotation, I received different answers. Interviewee 1 is convinced *“not affected – because they are proud to be auditor, so they are already independent – don’t really develop a close relationship, cares about his reputation – not be that involved since they are professional and can’t do a good job otherwise”* and also interviewee 3 expressed his concerns about auditor rotation and believes that rotation will not trigger a change rather raising costs. Interviewee 5 shared the same opinion by saying *“no change – if you want to hide something, you can hide it anyway – even if you change the auditor every year it will be no change, only extra costs”*. On the contrary, interviewee 2 and 4 agree with enhanced auditor independence and objectivity due to auditor rotation because of the more formal relationship between auditor and client. A long-term relationship is questionable, raising concerns about independence and objectivity of the auditor and thus negatively impacts audit quality.

##### 4.2.2.2 Perceived impact on trustworthiness of financial statements

Bringing up the next question if the trustworthiness of the financial statements will increase due to auditor rotation, my interviewees had diverse opinions. Three from five interviewees said they do not see an increase because of this regulation, for example interviewee 2 stated *“no, because I don’t think they (shareholders) care about auditing the firm as long it is a named firm”*. Interviewee 3 shared a different view since he believes that it will lead to an increased trustworthiness as auditors do not have the opportunity to get too involved in the company, which is in line with the view of interviewee 4 *“will be better, more independency of the auditor, client and auditor are less dependent on each other and therefore I also believe that the financial statement will be more transparent for everyone”*.

##### 4.2.2.3 Perceived likelihood to detect infringements and fraud

Furthermore, I noticed that four from five interviewees do not believe that auditor rotation will significantly affect auditor’s likelihood to detect more infringements in the accounting system as well as fraud. Interviewee 3 said *“I think in general auditors are really serious and good what they are doing, but I think to evaluate an audit successfully an in-depth knowledge about the client’s company is needed given in the case of a long-term relationship”*, while only interviewee 4 stated *“yes, because of increased independency of the engaged auditor – and different auditors will look differently on the financial statements, so more likely to find something what another one missed – so I think audit quality will improve as well”*.

#### 4.2.2.4 Perceived increase in costs through rotation

When asking whether auditing costs will decline or increase due to rotation, most of the respondents replied with a yes it will increase, because it will take more time to explain the new auditor the company, and more time means raising costs. Interviewee 5 particularly remarked *“particularly start-up costs will increase through extended explanation effort, like everything else government is controlling everything and taxes going up and this is a way of keeping track of the taxes, more and more rules to follow, and more difficult to follow”*. However, all interviewees said that the combination of costs and audit quality is important for their auditor decision rather than just the costs.

#### 4.2.2.5 Long-term auditor-client relationship increases audit quality

Moreover, I was curious to find if the interviewees perceive a better audit quality the longer the relationship with their auditor, and I got a variety of answers. Interviewee 1 and 2 agreed with my statement by saying that the auditor will know the business better over the years, hence better audit quality, while interviewee 3 expressed his concerns over the impact on quality and pointed out *“of course after some years the auditor knows the business, strategy of the company, but I see risk with that as well, that the auditor is too engaged in the company which could affect his or her independency”*. Interviewee 5 argued *“I don’t think the audit quality becomes better over the years – people they are coming are quite professional regardless of their years of experience, but I think after seven to ten years the quality will decrease as the auditor will become too personal attached to the management causing worries about his or her professionalism”*.

#### 4.2.2.6 Decreased likelihood to detect material misstatements in the initial years of the engagement

I further asked what they think about the fact that auditors are less likely to find material misstatements in the initial years of the audit engagement due to a lack of understanding the client’s business. Interviewee 2 and 3 totally agreed, because in their opinion auditors need to acquire knowledge of their new clients’ industry which takes time and increases the likelihood to oversee some things, particularly at the beginning. Interviewee 1 and 4 did not agree, because they believe that auditors are highly motivated at the beginning to find material misstatements, hence they conduct their audit accurately, and interviewee 5 argued *“depending on the auditor’s experiences – everything today is well-maintained you have computer programs for everything; everything is very standardised and there are so many rules and the problem is to follow the number of rules which are coming up each year that is a problem”*.

#### 4.2.2.7 Main reasons for audit failure

According to most of the interviewees, a strong connection between management and auditor is the main reason for audit failure as auditors become more dependent on the management over the years. For example, interviewee 4 stated *“a close relationship – company is paying the salary, so the auditor is forced to do what they are saying – they are getting paid and good paid they are signing off the balance sheets even though they are wrong”*. Also, interviewee 5 emphasised that a close relationship triggers an audit failure as it was the case with Enron.

#### 4.2.3 Perceived impact of audit firm size on audit quality

Concerning the impact of audit firm size and brand name on audit quality, I received similar replies. Interviewee 1 believes that a huge audit company like one of the Big 4 audit firms provides higher audit quality, because those firms are well-known and thus shareholders will



trust the audited financial statements. The interviewees also share the opinion that big audit firms have more expertise, hence can provide better audit quality. Nevertheless, interviewee 4 is an exception by stating *“it’s personal related/ individually related you can find good or bad auditors regardless the company”*. Due to the fact that most interviewees believe that big audit firms deliver enhanced audit quality, they agree that those firms are also entitled to charge higher fees. For example, interviewee 2 said *“of course they can charge higher fees as you as company can be sure that your financial statements are perfectly audited”*.

#### 4.2.4 Perceived impact of the joint-provision of audit and NAS on audit quality

When asking if their company also takes advantage of non-audit services like tax consulting from the same contracted audit firm who is doing their audit, two of the interviewees replied with a simple yes. One of them gave a more precise response *“yes consulting services in some areas where we can use them, but in some other areas we hire other audit firms’ due to EU regulation”*. Interviewee 3, 4 and 5 stated that their contracted audit firm only does the audit for their company. I also wanted to know their opinion concerning the impact of non-audit services on audit independence and thereby also audit quality. Three from five interviewees shared the opinion that the joint-provision of audit and NAS negatively impacts audit quality, because the auditor becomes too involved in the company thereby harming her or his independence and objectivity. For example, interviewee 3 said *“could be risky when someone mixes two different kinds of businesses, especially when one is regulated and the other one not, therefore I believe the ‘black list’ is a good solution with clear restrictions”*, whereas interviewee 1 is convinced that it cannot have an influence at all by saying *“no, because they already act formally and are professionals – besides that when providing both they have better knowledge of the business developed over years, therefore they can work more efficiently”* which is in line with the opinion of interviewee 5.

#### 4.2.5 The perceived ability of auditor rotation to solve the agency problem

I further questioned if they believe that auditor rotation will help to solve the agency problem existing between owners and management. The majority of the interviewees agreed that auditor rotation will not overcome the agency problem. Interviewee 4 argued *“no I don’t think so, an auditor is an auditor and should check that and sign it off every year and an auditor does not report to the companies’ owners only to the management or the audit committee”* and interviewee 5 replied *“make no differences in my opinion – when you are a public company you give your reports to your owners frequently every quarter –so no change .. and an auditor sticks to her or his regulations”*. Only interviewee 1 believes the problem will be solved through the rotation.

#### 4.2.6 The new regulation: audit firm rotation and audit quality

Considering the new EU regulation requiring public listed companies to change the audit firm after a period of 10 financial years, I asked my interviewees how they prepare themselves for the change. Surprisingly, three from five interviewees said that they have not done any preparation so far, while interviewee 2 replied *“we meet with different audit firms and talk about their conditions in order to enter a new engagement”*. I was especially curious to find their opinion about the most adequate audit firm rotation period. Three from five said seven years is an appropriate period as the auditor gets the chance to get to know the company a little better, but it is not enough time to develop a close relationship with the management thereby harming the auditor’s independence. Interviewee 3 on the contrary stated *“not sure, but it’s better and easier to work with someone who knows the business, but I see where the regulations*

are coming from, risk of misconduct – company perspective it is an additional cost, and administration that is required – don't wanna make a change”. Interviewee 4 argued every year would be appropriate in order to ensure good audit quality even though it is connected with high costs.

#### 4.2.6.1 Opinion about joint-audit mandate

I also figured out the interviewees' opinion about a joint-audit mandate. All of them agree that it is connected with high additional costs, but they believe that it will increase the audit quality because of two different views. Interviewee 1 replied *“it's good, cause more opinions – have different views – 2 persons looking at it can be from the same company or not, does not really matter but costly”*.

#### 4.2.6.2 Perceived effects on the auditing process

Moreover, I found that all interviewees hope that audit firm rotation will increase the effectiveness of the auditing process in order to save time and money and enhance audit quality. The majority of my interviewees believes that the new regulation will trigger a more standardised auditing process due to more governmental regulations. Interviewee 4 did not share this opinion, he said *“it will become more innovative, because different auditors have different views”*. Furthermore, all of them do not expect any change in the audit report and in the audit methodology since they believe the audit firm rotation will not affect the audit report and methodology themselves. What is more, all interviewees think that the company's preparation for the audit as well as the audit itself will be more time-consuming due to increased explanation and documentation work of their business. For example, interviewee 2 said *“yes, it will become more time-consuming as we need to explain the auditor our business and he or she needs to learn our business”*. Most of them said that the time consumption for both the preparation as well as the audit itself will increase by more than 20% as a result of the new audit firm rotation.

#### 4.2.6.3 Perceived effects on the audit market

When asking if the audit market will become more dynamic through increased competition in the auditing field, all of them agreed and argued that small firms will have greater opportunities due to the new regulation. For instance, interviewee 4 stated *“I think it will be more dynamic, more audit firms will enter the market, when considering the 'black list' – so more firms will be needed to conduct NAS – different audit firms also means different views .. a lot of change I would say – market will not be dominated by the Big 4 anymore from my perspective”*. According to most of the interviewees the new regulation will not bring major changes to the Swedish auditing industry. For example, interviewee 2 and 5 do not expect any change triggered by the audit firm rotation, while interviewee 4 stated *“better quality due to increased independence”*.

#### 4.2.7 General view about audit firm rotation

Three from five interviewees are in favour of the new regulation of audit firm rotation. Interviewee 1 said *“I don't think it will solve the problem – better solution is joint-audits for large companies – when you wanna do dirty business you can do it, however, audit firm rotation could be a good thing too – you get a fresh view”*. Interviewee 3 argued that audit firm rotation offsets the lack of independence and objectivity caused by a long-term relationship, hence audit quality will be improved which is in line with the answer of interviewee 4 who simply said that the rotation period could be even shorter. On the contrary, interviewee 2 is

completely against it and stated, “it increases the time management instead of doing business and earn money – need to spend time with auditor to explain business first, and in the second year it will take longer to do the audit and it will increase costs”. Also, interviewee 5 is convinced that a long-term relationship between auditor and client offers more value to the client as the auditor has more time to get an in-depth knowledge about the client’s business leading to a more professional feedback from an experienced auditor.

#### 4.2.8 Summary of main findings public listed companies

Main findings	Interviewee				
	1	2	3	4	5
High satisfaction with current auditor	X	X	X		X
Audit quality is key factor when deciding on auditor	X	X	X	X	X
Areas of audit opinion	Tangible assets, bad debts, reconciliation, acquisitions, tax issues, accounting principles and risk assessment				
Appointment of auditor through a regulator in future				X	
Enhanced objectivity and independence of the auditor		X		X	
Increased trustworthiness of financial statements			X	X	
Increased likelihood to detect fraud through rotation				X	
Increased costs through rotation	X	X	X	X	X
Enhanced audit quality the longer the relationship	X	X			
Decreased likelihood to detect material misstatements in the initial years of the engagement		X	X		
Main reason for audit failure	Close relationship between auditor and client				
Audit size and brand-name positively impact audit quality	X	X	X		X
Large audit firms are entitled to charge higher fees	X	X	X		X
Same audit firm for NAS and audit	X	X			
Joint-provision of NAS and audit negatively impacts audit quality		X	X	X	
Auditor rotation solves the agency problem	X				
Adequate rotation period in years	7	7		1	7
Increased audit quality through joint-mandate	X	X	X	X	X
Increased effectiveness of the auditing process	X	X	X	X	X
More standardised audit process	X	X	X		X
No change in audit report and methodology	X	X	X	X	X
More time-consuming preparation and audit process	X	X	X	X	X
More dynamic audit market	X	X	X	X	X
In favour of audit firm rotation	X		X	X	

Table 6: Key findings of public listed companies

#### 4.3 Part two – interviews with audit companies

For a better understanding, I named the interviewed auditor of company X, auditor X and the interviewed auditor of company Y, auditor Y in the following section.

### 4.3.1 Auditing and role of auditor

#### 4.3.1.1 Average length of auditor-client relationship

At the beginning of the interview I was curious to figure out how many audits the auditors conduct on average every year. The number ranges between 70 and 90 every year. Moreover, I was interested to know the average duration of their relationship with their clients. Eva Melzig said “*some 15-20 years, average I would say 10 years*”, while auditor X said their average relationship lasts for about 13 years, and for auditor Y the average length with their clients is 10 years.

#### 4.3.1.2 Modification of audit opinion

When asking if one of their clients has ever asked them to modify their audit opinion, I received similar answers. Eva Melzig replied “*not modify, but we always have a discussion, because when I have a different opinion I need to explain it why and this maybe could lead to a small modification - but I aim to make management, board and owners to understand my point of view – I can’t just make my audit opinion and send it off, they need to understand what I am talking about – we aim to find issues as soon as possible in the audit year – so that the company has the chance to correct it*”, which is similar to the answers of auditor X and Y who just said no never, but it needs to be taken into account that auditors are human beings so sympathising gets involved in the audit process, nevertheless, an auditor should be able to distinguish whether a statement made by the client is true or false, and whether a modification is necessary or not.

#### 4.3.1.3 The appointment of an auditor through a regulator

Further, all of the interviewees shared the opinion that the appointment of an auditor through a regulator is not the solution to the problem as it will only increase costs. Eva Melzig stated “*not the management of the company, but the owner – he should take this decision – start-up costs will increase immensely as well*”, while auditor X said, “*I think the company should decide which auditor – as they will find out which auditors are good in their industry, regulators might just choose randomly and the company itself is the one who needs to trust the auditor*”. Also, auditor Y agreed and stated that it is illogical as the relationship between auditor and client is personal and based on trust.

### 4.3.2 The impact of auditor rotation on audit quality

#### 4.3.2.1 Perceived impact on auditor’s independence and objectivity

I noticed that according to all interviewed auditors, neither independence nor objectivity are affected by auditor rotation. Eva Melzig argued “*don’t think the rotation is the answer to the problem, cause auditors are really aware what they are allowed to do or not/affects our internal life go for an audit or advisory services will affect this decision*”, which is in line with auditor Y who stated “*no I don’t think so, because we all act professionally anyways, why should we change now due to the rotation*”. Moreover, all respondents share the opinion that the trustworthiness of the information will not be affected. Auditor X said, “*will not be affected as I don’t think that the independence and objectivity will increase, auditor stick to their given rules – so no change here*”.

#### 4.3.2.2 Perceived likelihood to detect infringements and fraud

When asking if the rotation will affect the auditor's likelihood to detect more infringements in the accounting system or fraud, I was given diverse answers. Eva Melzig replied "*we know our rules and regulations and we stick to them – no change here*", auditor X shared the same opinion and is convinced that his working style will not change through rotation, and he thinks that auditors will be exposed to more pressure when it comes to finish their work, thus they will be forced to rely on previous audit work. However, auditor Y takes the view that every auditor looks differently at the client's financial statements, hence a new auditor could find something what a previous auditor has overlooked. Therefore, he believes that the probability to discover misstatements will increase through the new regulation as well as the audit quality.

#### 4.3.2.3 Perceived increase in costs through rotation

Furthermore, I observed that all auditors expect an increase in costs through rotation. Auditor X and Y said that the costs will rise due to increased tendering processes, because of the rule to keep their clients. Eva Melzig "*will be at the same level – the tender will be an increasing price that's the only thing we can only fight with – we tend to fight with the prices within the Big 4 group*".

#### 4.3.2.4 Long-term auditor-client relationship results in constant level of audit quality

I was also interested in their opinion if audit quality results in a constant level over the years. All interviewed auditors confirmed my statement, and I received various arguments. Eva Melzig said "*yes, we invest a lot in the first year of an audit and we are willing from a firm's perspective to invest to ensure that we find everything – it's tricky when you find something in the second year of the audit engagement what you should have found in the first year*", while auditor X argued "*yes as we always try to give our best and find everything, we don't wanna disappoint our clients nor destroy our reputation*". Auditor Y just said that he always puts in lots of effort and tries to stay aware of all changes in the industries environment as well as all new upcoming regulations but the fundamentals for a constant level are procedures, techniques and tools used during the audit process.

#### 4.3.2.5 Decreased likelihood to detect material misstatements in the initial years of the engagement

When asking about the decreased probability of material misstatements in the initial years of the engagement due to a lack of understanding the business, the respondents gave me varied answers. Eva Melzig provided a detailed response "*valuation problems, internal control issues like the system is not working according to the system/ set up like it should be – you should figure that out in the first year of engagement because otherwise in the second years to have an explanation issue to the Board why did you not say something in year one (misstatements you normally find) – so we really spend a lot of time in the first year to follow through all transactions, how estimates and valuations are done, what input management have on these estimations etc. – to ensure that we are okay how the company is performing their business*", and auditor X just said that it takes time to get to know the business, but every auditor is highly motivated at the beginning of each new engagement. Auditor Y said, "*of course I try my best, but I am just a human being so mistakes can happen particularly in the beginning where you need time to get to know the business*".



#### 4.3.2.6 Main reasons for audit failure

According to the majority of the interviewed auditors, complexity is the main reason for audit failure. Eva Melzig said *“complexity, auditors have not been paying attention for all the questions, more in the financial sections than in manufacturing companies – lots of specialists involved, accreditation not allowed to audit a financial institution as I don’t have an accreditation for it for example, lots of safeguard procedures”*, and auditor X takes the same view that complexity could lead to audit failure. Whereas auditor Y believes that missing information from the client’s side and poor planning are some common reasons for audit failure.

#### 4.3.3 Perceived impact of audit firms size on audit quality

I was curious to figure out what my interviewed auditors think about the role of audit size and brand-name and their impact on audit quality. All of them shared the opinion that large audit firms benefit from more expertise due to the number of qualified colleagues. For instance, Eva Melzig said *“size has a big advantage, because I have so many qualified colleagues to ask – being an auditor is a lonesome work because at the end of the day I am alone when I find the auditor reports, the regulations, the taxes, the IT systems they are also complex I need a lot of expertise, friends to ask and how to do especially using the audit – and we can afford to have this, we really care that we don’t harm our brand name”*, which is in line with the perspective of auditor X who is convinced that bigger firms have better opportunities in terms of knowledge sharing due to the increased number of skilled employees, and of course work of well-known companies is perceived as high-quality work. Similarly, auditor Y spoke about the expertise advantage in large companies and he also emphasised how important it is for employees of well-known companies to work more accurately in order to protect the company’s brand name.

When asking about their opinion if auditors working in large audit firms are entitled to charge higher fees, I received different answers. Eva Melzig said *“I mean I can see where it comes from, but I would not say that auditors working in a big firm are better than those working in small firm - in big firms, they have the advantage that they have better opportunities to ask others, therefore I think they should not ask for more money”*, while auditor X and Y stated that auditors specialised in a particular industry are allowed to charge higher fees, because they are aware of all regulations and risks in this specific industry, but specialised auditors are not necessarily only in big audit firms.

#### 4.3.4 Perceived impact of joint-provision of audits and NAS on audit quality

All respondents shared the opinion that the joint-provision of auditing and non-audit services negatively impacts the auditor’s independence and thus audit quality. Eva Melzig emphasised *“yea should be separated and we have that already – some clients have that question regulated what the auditor is supposed to do and not – nothing to do with rotation –cause when I have a client who says I should do that and that – and I personally like it, because I don’t wanna do a lot of consultancy to my audit clients, because I am responsible for the clients – and I must know what I am I doing for my clients – not expert in everything – not implementing IT not my business and should not be part of it”*, also auditor X argued that it should be separated, otherwise the auditor gets too involved in the company, which is likely to negatively impact the auditor’s independent actions, thus adversely influencing audit quality. Therefore, the implementation of the ‘black list’ is a perfect solution to the problem. Auditor Y agreed and added that in Sweden auditors conducting the audit for a client firm are not allowed to offer acquisition and accounting services for the same firm.

#### 4.3.5 The perceived ability of auditor rotation to solve the agency problem

I found that the interviewed auditors do not believe that the information gap between owners and the management will decrease. According to Eva Melzig, there will be no change *“only because the auditor is from a different firm or a different person does not mean the audit rules change”*. Also, auditor X and Y cannot see the rotation as the solution, because an auditor reports to the audit committee or managers and not necessarily to the company’s owners, therefore an audit cannot overcome the agency problem.

#### 4.3.6 The new regulation: audit firm rotation and audit quality

When asking what preparations, they are conducting to deal with auditor rotation, I was given detailed answers. Eva Melzig replied *“first of all we look into our clients and see when it will affect them as there are some dates to pay attention too, in one case signed off the engagement because of the seven years rule, in that case it was not mandatory for the client to change the audit firms, so of course I try to introduce the client with a colleague to keep the client within the firm of course, and it takes quite a long time to find the right people, then of course we look at our competitors to prepare ourselves for the audit tender, last year there was a lot of tender, we spent so much time on preparing tender, because companies are not really willing to change audit firms – they have to go out to a tender as they wanted to keep the audit firm, lot of tender work for nothing either way – not easy to prepare those tenders for big companies”*, also auditor X and Y stated that they check the length of their prevailing engagements in order to figure out those which will be affected immediately. At the same time, they analyse their competitors to prepare themselves for the tender process.

I was curious about the rotation period being adequate in the opinion of my interviewed auditors. Eva Melzig is convinced that seven or eight years are a good period to change the auditor in charge, but she cannot see a point why the client should change the audit firm after ten years. Auditor X stated, *“I would say five years, otherwise it’s likely that you get too involved in the entire company”*, and from auditor Y view 10 years are adequate as it is enough time to get to know the company, but at the same time to leave to see something new.

##### 4.3.6.1 Opinion about joint-audit mandate

In the eyes of the respondents a joint-audit mandate is not beneficial for audit firms rather for client firms. Eva Melzig said *“it’s hard with divided responsibility and hard to share information – in those big companies with subsidiaries we need to make an efficient audit to work together with our colleagues from abroad – need to work with colleagues – all subsidiaries within KPMG work in the same system we have, the same audit develops methods/strategies - joint audit would not be cost efficient as you can’t share your work papers with any other audit firm”*. Auditor X and Y share the same opinion, and according to auditor Y, the division of responsibility is challenging as well as the information sharing process with a different audit firm considering that every firm has a different one. However, he can see a benefit for client firms as they receive diverse opinions and for small audit firms’ opportunities to enter the market, but there is no advantage for a big audit firm just extra work.

##### 4.3.6.2 Perceived effects on the auditing process

When asking if there will be an increased pressure on the effectiveness of the auditing process, all respondents replied with a yes. The interviewed auditors believe that every auditor looks at the client’s financial statements from a different perspective, hence one auditor can detect what has been overlooked by another auditor. Therefore, auditors are exposed to an increased

pressure to work accurately and try to find everything, otherwise their reputation could be harmed. Moreover, all agreed that the audit process will be more standardised. For instance, Eva Melzing said *“more standardised, because the clients rely on the IT systems and have spent huge amount of money in valuation systems – more with an IT focus”*, and auditor X is convinced that in future IT systems will be developed to simplify and fasten the audit process thus triggering standardisation. Also, auditor Y shares the view that the audit will be more standardised, because he believes that there will be even more rules for auditors that in the end everybody will conduct the audit in the same way.

Furthermore, I discovered that according to all auditors interviewed, the new EU regulation triggers changes in the audit report for public listed companies, for example the report must include more detailed information about the audit performance and the audited financial statements. The same counts for the audit methodology where Eva Melzig stated *“there will be a change in the methodology, but not based on the audit firm rotation rather on the EU regulation itself”*. I was also interested to find if the auditors believe that the preparation of audits as well as the audit itself will be more time-consuming due to the new regulation. According to Eva Melzig *“the first year is always very very time-consuming – costs will stay on the audit firm because this is our investment to get the client – to find them have subsidiaries around the world it’s so complex, I don’t think the regulators know how complex it is – spend a lot of time for negotiations and administration, more than 40%”*, also auditor X and Y argued more time will be needed to understand the new client’s business and due to rotation this will happen more often, hence the time-consumption will rise by more than 20%.

#### 4.3.6.3 Perceived effects on the audit market

In the opinion of the auditors interviewed, the new regulation will trigger a more dynamic audit market through increased competition in the auditing field. Auditor X stated, *“indeed the market will be more dynamic, particularly when considering the ban of the ‘Big 4 only’ clauses – meaning that the audit market will be driven by more firms”*. Eva Melzig and auditor Y share the same opinion and added that this new regulation will create excessive opportunities for small audit firms, especially when taking into account the further prohibitions on the joint-provision of audits and non-audit services, and the introduction of joint-audit mandates.

When asking about the change in the Swedish audit industry, I received diverse answers. Eva Melzig said *“I don’t know, but I think it will be the same for the companies struggling for the big audit firms – don’t think it will be easier due to the complexity of the clients – maybe you see some people to rotate from one firm to another because of that, cause the planning will be much harder to have the right person in the right office who wanna tender”* and auditor X argued that he believes that smaller audit firms will get bigger opportunities, but he does not expect a big change.

#### 4.3.7 General view about auditor rotation

At the end of the interview the auditors were asked about their general view on audit firm rotation. Eva Melzing said *“it’s good that the engagement partners rotate – that we have a rotation on number two, not a law – don’t see firm rotation as input to the rules audit and non-audit services”*, which is in line with the statement made by auditor X *“I think audit partner rotation is good and audit quality will be enhanced – but audit firm rotation I don’t see a benefit – I mean if it’s another auditor, it’s a new view anyways”*. Also, auditor Y argued *“audit partner rotation is good – cause in a long-term relationship you get too familiar with your client company after a while and rather decreases audit quality than strengthens it due to*



*the lack of independency and objectivity caused by the lengthy tenure – but changing the audit firm I don't know why this new regulation is necessary – just brings more costs due to increased tendering as well as more time is needed to prepare those tenders”.*

#### 4.3.8 Summary main findings audit companies

Main findings	Auditor		
	Eva Melzig	Auditor X	Auditor Y
Average relationship with clients	10 years	13 years	10 years
Appointment of auditor through a regulator in future	Not a good idea		
Enhanced objectivity and independence of the auditor	No change		
Increased trustworthiness of financial statements	No change		
Increased likelihood to detect fraud			X
Increased costs through rotation	X	X	X
Constant audit quality over the years	X	X	X
Decreased likelihood to detect material misstatements in the initial years of the engagement			X
Main reasons for audit failure	Complexity, incomplete and hidden information, poor planning		
Audit size and brand-name positively impact audit quality	X	X	X
Large audit firms are entitled to charge higher fees		X	X
Joint-provision of NAS and audit negatively impacts audit quality	X	X	X
Auditor rotation solves the agency problem	No change		
Adequate rotation period in years	7-8	5	10
Increased audit quality through joint-mandate	No, just extra work		
Increased effectiveness of the auditing process	X	X	X
More standardised audit process	X	X	X
No change in the audit report and methodology	regulation includes changes		
More time-consuming preparation and audit process	X	X	X
More dynamic audit market	X	X	X
In favour of audit firm rotation	No		

Table 7: Key findings of audit companies

## 5 Discussion

Chapter five gives the reader a detailed insight into the analysis of the empirical findings presented in the previous chapter. More precisely, the findings gained from the semi-structured interviews with audit firms and client companies are compared with existing theories as described in chapter two, the literature review. The discussion in this chapter is about the impact of auditor rotation on audit quality, including topics such as the role of auditor, audit size, non-audit services and the agency theory. Hence, it will provide an understanding how Swedish audit firms and public listed companies perceive the impact of auditor rotation on audit quality compared to existing theories.

### 5.1 Auditing and role of auditor

#### 5.1.1 The present auditor-client relationship

Previous events, such as the Enron case for example, have drastically changed the audit market for both auditors and clients (DeFond & Zhang, 2014, p. 275). Due to those events, capital markets experienced a declining trust in the decision-usefulness of financial accounting and auditing, triggering the need for a new regulation aiming to restore and improve market stability as well as regaining investor's confidence (Velte, 2012, p. 81; Razinger-Sakel & Schoenberger, 2015, p. 61). According to the EC, mandatory audit firm rotation after a period of 10 financial years seems to be the solution to the problem (Velte, 2012, p. 81). Based on this fact, I aimed to figure out the average length of engagement periods of the interviewed companies, which include both audit firms and public listed companies, and if the interviewed client companies have a policy for changing their auditor. All of my interviewed auditors mentioned that the average length of their engagements varies from 10 to 13 years, while most of the public listed companies engaged their current auditor two to three years ago. My findings reveal that none of the public listed companies possess a policy for changing their auditor apart from the existing EU regulation requiring public listed companies to change their audit partner after a period of seven years. However, some interviewed public listed companies have already changed their auditors, the reasons were non-satisfaction of the combination of quality, costs and knowledge of their business as well as the existing EU law. Another reason stated by one interviewee was that his auditor only focused on the simple detection of material misstatements and if the financial statements are in compliance with the GAAP, not taking into account the quality of them. This statement supports the finding of DeFond & Zhang (2014, p. 281) study who discovered that an auditor offering high audit quality goes beyond the simple detection and provides a greater assurance that the presentation of the financial statements faithfully reflects the audited companies' economic situation.

#### 5.1.2 The importance of audit quality when deciding on auditor

In fact, audit quality plays a crucial role for all interviewed public listed companies when it comes to deciding on the auditor as everyone is pursuing high quality audited financial statements. According to all interviewees representing public listed companies, high audit quality is perceived as a balanced combination between quality and costs, auditor's in-depth knowledge about the client's company, and auditor's creativity to solve problems. Considering that the auditors' providing high audit quality goes far beyond the simple detection of material misstatements and fraud, as already mentioned above, it needs to be stated that my findings show that the majority of my interviewees representing public listed companies are satisfied with the audit quality of their present auditor. Reasons for this include great organisation skills

of the auditor, business knowledge and the provision of advice how the quality can be enhanced.

### 5.1.3 Modification of an audit opinion

Furthermore, an auditor is required to express an audit opinion guaranteeing a fair presentation of the financial statements in compliance with GAAP (Lu & Sivaramakrishnan, 2009, p. 72). Based on this fact, I had the aim to see if an auditor has ever been sympathised to modify her or his audit opinion, and what main areas of audit opinion the interviewed public listed companies receive. What emerged during the interviews with auditors is that they were never forced or sympathised by a client to modify her or his opinion. Nevertheless, sometimes the auditor perceived something in a different way causing discussions with the client and may led to a modification of the audit opinion. Considering that an auditor is a human being sometimes sympathising gets involved in the audit process, however, the auditor should have enough experience to figure out which statements made by the client are true or false and if there is a need for a modification or not. It is important that an auditor always acts professionally and sticks to her or his rules. When it comes to the main areas of audit opinion (received), I found that those are tangible assets, risk assessment, bad debts, reconciliation, acquisitions, tax issues and accounting principles. None of the public listed companies interviewed had to report a material misstatement in the past five years.

### 5.1.4 Appointment of an auditor through a regulator

The European Commission is thinking about the feasibility of a scenario that the appointment of an auditor should be done through a regulator rather than by the client firm itself. This new concept aims to prevent the risk of increasing bureaucracy and societal advantages of traceably independent appointments (EC, 2010, p. 11). Results of my research show that this concept is perceived as illogical by both groups interviewed, taking into account that relationships between auditors and clients are personal and based on trust, so why should an external person appoint the auditor for them. Another aspect mentioned in this context by an interviewee of a public listed company was that a regulator does not know the client's company and might not be aware of auditors experienced in the client's business fields and thus the appointment of an auditor by a regulator is worthless due to a random decision. Also, the majority of my respondents believe that this new concept will increase the start-up costs drastically. The only exception is interviewee 4 who stated that it is a good solution in order to keep the auditor, the management and the board of directors' independent from each other.

## 5.2 Auditor Rotation vs. long-term auditor-client relationship impact on audit quality

### 5.2.1 Perceived impact on auditor's independence and objectivity

Lots of research has been carried out about the benefits and drawbacks of auditor rotation as well as its influence on audit quality (Forunes Dattin, 2017, p. 45). According to GAO (2003, p. 22) auditors are more likely to act independently under auditor rotation, because they are aware that their time at the client's company is limited and thus there is not enough time to develop a close relationship with the management of the client's company. Therefore, auditors are more likely to resist management's pressure, triggering a more objective evaluation (Geiger & Raghunandan, 2002, p. 67). These facts are proven by interviewee 2 and 4 who emphasised that a long-term tenure is doubtful due to the establishment of a too close relationship between

auditor and client, and likely to adversely affect auditor's independence and objectivity and thus also audit quality. However, during my research I found that my respondents representing audit companies do not share the view of interviewee 2 and 4, and are convinced that auditors stick to their given rules and act professionally. Consequently, neither auditors' independence nor their objectivity will change through the new regulation. Also, interviewee 1, 3 and 5 do not support those statements and argue that auditors act professionally as they are not aiming to lose their reputation, and in case public listed companies would like to hide something they will do it anyways. Further, they are of the opinion that audit quality is higher in a long-term auditor-client relationship because an auditor needs time to get familiar and knowledgeable with the client company, its processes, risk and accounting systems in order to make a valuable assessment.

### 5.2.2 Perceived trustworthiness of financial statements

When speaking about increased trustworthiness of financial statements due to rotation, what was mostly mentioned by nearly all respondents that they do not see enhanced trustworthiness as auditors are aware of their valid rules they need to comply with, and it is believed that the financial statements of a well-known audit firm are trustworthy and of high quality. The exceptions were interviewee 3 and 4 who stated that due to the new regulation auditors' independence will be strengthened and also the financial statements will become more transparent for the public. This finding supports the aim of the EC (2016) to provide more transparent financial statements to investors and to reinforce auditor's independence and professional scepticism.

### 5.2.3 Increased likelihood to detect infringements and fraud

What is more, Forunes Dattin (2017, p. 45) pointed out in her work that mandatory auditor rotation raises auditor's likelihood to detect material misstatement and fraud in client's financial statements. This is because a new auditor will look differently at the accounting practices, thereby bringing a different view and a dependent auditor's eagerness to fulfil the desires of the client's management will be reduced. Furthermore, she highlighted in her study that a lack of auditor's scepticism decreases the ability to discover fraud. Those facts were explicitly mentioned by auditor Y and interviewee 4 who said that a new auditor views the financial statements from different angles and thus the probability to discover mistakes overlooked by a previous auditor is increased. Moreover, the enhanced independence of a new auditor contributes positively to improved audit quality. Nonetheless, the majority of the respondents do not agree and argue that a long-term auditor-client relationship is essential for the reduction of material misstatements, because extensive knowledge about the client's company gained through a lengthy tenure contributes to a successful audit. In addition, auditor X stated that auditors will be exposed to more time pressure when conducting their audit and will be forced to rely on previous audit work, thus likely to decrease audit quality. This supports the results of the study conducted by Brody & Moscové (1998, p. 5) who discovered that auditors, in the case of auditor rotation, are tempted to trust in previous audits as they are exposed to immense pressure finishing their work, thereby decreasing audit quality.

### 5.2.4 Perceived increase in costs through rotation

What emerged during the interviews is the fact that almost all respondents believe in an increase in costs due to rotation. It directly affects the cost of the first year of the engagement, and notably for client companies as new auditors need to acquire knowledge from scratch, which takes a lot of time and time is money, whereas audit companies will be exposed to

increased tendering costs triggered by the new regulation of audit firm rotation. This finding is in line with Forunes Dattin (2017, p. 45) who discovered that auditor rotation will raise audit costs for both parties involved in the audit process due to the learning costs and the limited number of available audit firms possessing the scale and industry understanding required to carry out a specific client engagement. On the contrary, Eva Melzig, auditor of KPMG, argued that the prices will be at the same level, because within the Big 4 group it is usual to fight with prices, so there will be no change. Nevertheless, all public listed companies interviewed emphasised that they are willing to pay higher costs for high audit quality.

#### 5.2.5 Long-term auditor-client relationship results in a constant level of audit quality

From the auditor's perspective audit quality will result in a constant level the longer the auditor-client relationship. Auditors invest lots of time at the beginning of each engagement and try their best to understand and find everything which needs to be improved, and keep up this working style during the entire length of the engagement. According to the auditors interviewed, fundamentals for a constant level of audit quality are procedures, tools and techniques used during the audit process. In contrast to audit companies, two respondents representing public listed companies are convinced that audit quality will be enhanced the longer the auditor-client relationship due to the increased knowledge about the client's company processes, strategies and operations. This finding is confirmed by Forunes Dattin (2017, p. 45) who found that auditor rotation could lead to a decline in audit quality caused due to auditor's lack of knowledge of client's practices, operations and processes. Whereas, interviewee 3, 4 and 5 argued that the audit quality is likely to decline after a period of seven to ten years as they are convinced that an auditor gets too close to the management thereby triggering concerns about the auditors' professional scepticism. Thus, confirming the statement made by supporters of auditor rotation who believe that the long-term auditor tenure rather harms auditor's independence and audit quality than improving them (Forunes Dattin, 2017, p. 45).

#### 5.2.6 Decreased likelihood to detect material misstatements in the initial years of the engagement

It was found that particularly in the first years of a new engagement inexperienced auditors in the new client's industry are likely to oversee misstatements, hence delivering low audit quality (Elder, Lowensohn & Reck, 2015, p 96). This fact seems to be valid for both groups, auditor Y and interviewee 2 and 3 who stated that a new auditor needs plenty of time to gather knowledge about the specific client's business and thus the probability to overlook some issues are high and the audit quality low. On the contrary, three from eight respondents emphasised that auditors are eager to enter the new audit engagement, hence highly motivated and enthusiastic triggering an improved audit quality. Additionally, Eva Melzig explicitly emphasised that it is crucial to put in much effort in the beginning of each engagement in order to avoid explanation issues to the Board in the following years, and to provide good audit quality. Besides that, according to interviewee 5 it depends on the auditor's experience, how she or he can deal with all the new regulations coming up each year and all the computer programs connected with the audit process.

### 5.2.7 Main reasons for audit failure

From the auditors' perspective, common reasons for audit failure are missing or hidden information from the client site and poor planning. Also, the complexity of the audit process is perceived as a reason for an audit failure due to the fact that lots of specialists are involved and so many regulations to attend to, therefore it is hard to keep track of everything. However, in order to conduct an audit successfully, complete information is required, otherwise this will result in an audit failure and the auditor will have difficulties to accurately assess the risk of the client company. Whereas from the client's perspective the main reason for an audit failure is the missing independency of an auditor in a long-term auditor-client relationship. Due to the close relationship, an auditor depends on the management and is willing to cooperate with them, helping to hide information, for example, which in the long run is likely to end up in an audit failure such as the Enron case. This is proven by Myers et al. (2003, p. 780) who found that an audit failure can be the result of a failure in auditor independence or audit quality negatively affecting all parties trusting the correct presentation of the financial statements in compliance with GAAP.

### 5.3 The perceived effects of audit size and brand-name on audit quality

As mentioned by Choi et al. (2010, p. 74), large audit firms with international brand names such as the Big 4 provide higher audit quality services compared to small audit firms, hence are entitled to charge higher fees. A possible reason for the quality difference between large and small audit firms could be the circumstance that large offices benefit from more in-house experiences and expose over more shared human capital in their offices. Furthermore, due to the fact that large offices have more engagement hours and more skilled workers to consult with, auditors have greater opportunities to acquire know-how in discovering misstatements in the client's financial misstatements (Francis & Yu, 2009, p. 1523). As I could see through my research, these statements do not just stay in theory but turns as well into reality. Almost all the respondents emphasised that big audit firms benefit from extensive knowledge due to a large number of auditors specialising in different industries. Consequently, auditors working in large well-known audit firms have the opportunity to consult with many skilled auditors. For all these reasons, large audit firms with famous brand-names provide higher audit quality compared to small audit firms not profiting from those possibilities of big audit firms. The exception was interviewee 4 who mentioned that it is individual-related, a good auditor can either work in a large or a small company it does not depend on the size or on the name of the company she or he is working for.

What was stressed by two auditors asked is that large audit firms employ a number of industry-specialised auditors to ensure every section of the clients' industries is covered. The industry-specialised auditors charge higher fees as they are familiar with all regulations and rules of a specific industry, thereby knowing how to assess and evaluate specific risks connected with this industry, whereas a non-specialised auditor will not be able to carry out an appropriate evaluation due to a lack of industry knowledge, hence not entitled to charge high fees. On the contrary, Eva Melzig, auditor of KPMG, explicitly stated that auditors working in large firms have greater opportunities to ask others, but it does not mean that they should charge higher fees. Four from five respondents representing client firms mentioned that they are willing to pay higher fees for enhanced audit quality provided by an auditor working in a large well-known audit company.



## 5.4 The effects of the joint-provision of audits and NAS on audit quality

The joint-provision of audit and non-audit services is a heavily discussed topic among legislators and regulators as it is believed to negatively impact auditor independence and thus audit quality (Habib, 2012, p. 243). Up to now, there has been no official ban preventing auditors from providing both audits and non-audit services, such as tax advice and consultancy, to their clients in the entire European Union (EU, 2006), but there are some exceptions, for example country-specific regulations regarding the joint-provision of NAS. Evidence from research indicates that the joint-provision of audits and NAS has two main advantages, knowledge spillover and contractual economic, hence audit efficiency can be enhanced through joint-provision (Habib, 2012, p. 215). Interestingly, only interviewee 1 and 5 agreed with this statement by pointing out that the joint-provision of audits and NAS enables the auditor to gain extensive knowledge about the client's company, therefore she or he is able to conduct the audit efficiently, which in turn leads to increased audit quality. On the contrary, six out of eight respondents are in line with the study results of Habib (2012, p. 215) showing that the joint-provision of audit and NAS strengthens the economic bond between auditor and client, thereby raising concerns about audit quality due to decreased auditor's independence. Almost all respondents mentioned that audits and non-audit services need to be separated as auditors will get too attached to the client's business, thereby impairing auditor's independence and thus audit quality. An auditor emphasised that auditors based in Sweden are prohibited to provide acquisition and accounting services to their clients, but they are allowed to offer tax advice, advice on mergers and consultancy. Further, all respondents seem to be informed about the so called 'black list' implemented by the EU, which imposed additional bans concerning the joint-provision of audits and specific non-audit services. It is interesting to note that, as underlined by Eva Melzig, these two services are already separated at KPMG, and some clients have rules which services an auditor is allowed to do additionally to the audit or not.

## 5.5 Overcoming the agency problem due to auditor rotation

Information asymmetries and differing interests between agents and principals, the so-called agency problem, reduce the credibility of financial information, thereby triggering a loss of trust between those two parties involved. In order to solve this problem a third party, an auditor acting as agent, tries to align the interests of those two parties. Nevertheless, an audit requires a tight relationship between auditor and the client's management, thereby raising concerns about auditor's independence and objectivity and thus audit quality (The Institute of Chartered Accountants in England & Wales, 2005, p.6-10). During my research, I aimed to figure out how audit firm rotation could solve the agency problem between the companies' owners and the management. According to my respondents, audit firm rotation will not help to close the gap between principal and agent, because an auditor meets and reports to the audit committee or to the management and not to the owner of the client company. The exception was interviewee 1 who pointed out that the agency problem could be tackled with the help of rotation due to enhanced audited financial statements examined by different auditors from different angles. Those financial statements are accessible for both parties involved, the agent and the principal who thus receive the same information.

## 5.6 The audit firm regulation

### 5.6.1 Adequateness of the audit firm rotation period

In June 2014, the European Commission implemented a new regulation aiming to enhance audit quality by the means of strengthening auditor independence and professional scepticism, requiring public interested entities (PIEs) to rotate their audit firm after a period of 10 financial years (EC, 2016). However, the same audit firm can be reappointed for another period of 10 years after having conducted a public tendering process and another period of 14 years in case of joint audit (Cameran et al., 2015, p. 8). As pointed out in my research, all respondents possess the knowledge about this new regulation. When asking about the adequate rotation period, only one auditor considered 10 years as an appropriate one, because in his opinion an auditor has enough time to get to know the client's business, strategies and operations, and at the same time he mentioned that 10 years are not enough to get too involved in the company, meaning that the auditor starts cooperating with the client's management rather than just focus on her or his audit tasks. On the contrary, the majority of the respondents stated that a period of 10 years is too long and an auditor becomes too familiar and too attached to the client's company, thereby harming her or his independence and objectivity and thus decreasing audit quality. A reasonable period would be between five and seven years. The exception was interviewee 4 who argued that it would be beneficial to change the auditor every year in order to ensure high audit quality, however, a change of auditor is always connected with high costs.

### 5.6.2 Perceived opinion about joint-audits

Another aspect that needs to be mentioned is that joint-audits could create opportunities for small audit firms, considering that the present audit market is dominated by the Big 4 accounting firms. Furthermore, joint-audits are likely to contribute to a high audit quality, bearing in mind that two or more parties are looking at the client's financial statements (EC, 2016). In fact, all respondents representing public listed companies supported the statement that joint-audits are advantageous, because two different people are looking at the financial statements from different angles, hence audit quality can be improved immensely, but at the same time it is associated with high additional costs paying for the work of two auditors. Auditor Y explicitly confirmed that joint-audits offer opportunities for small audit companies in the Big 4 dominated audit markets. On the contrary, Eva Melzig and auditor X claimed that joint-audits are extra work for audit companies as it is provoking to divide responsibilities, and every audit firm has a slightly different information sharing process which could be an additional challenge. Nevertheless, two from three auditors emphasised that they could see the benefits for public listed companies getting different perspectives, but not for audit companies as the audit efficiency will be negatively impacted due to increased work.

### 5.6.3 Perceived effects on the auditing process

As already mentioned above, the new regulation is aiming to enhance statutory audits by strengthening auditor independence and offering audited financial statements of a high quality to investors (EC, 2016). Based on the defined goals by the European Commission, I had the intention of finding what impact the new regulation has on the effectiveness of the audit process and whether the audit process becomes either more standardised or more innovative. What emerged during the interviews with auditors is the fact that there will be an increased pressure on the effectiveness of the auditing process since a larger number of auditors with different views look at the clients' financial statements, thus increasing the likelihood to find something what another one overlooked. Therefore, auditors are exposed to a growing pressure that their



work is carried out correctly, otherwise their reputation could be harmed. In contrast to auditors, interviewees of public listed companies expressed their hope of a more effective audit process in order to save time and money, and to improve audit quality. When speaking about a more standardised or more innovative audit process, it is interesting to underline that most respondents from both audit firms and public listed firms expect a more standardised audit process as a result of the new regulation. My findings reveal that, from the auditors' perspective, the standardisation of the audit process is triggered by the development of a growing number of IT systems which brings about a simplified and faster audit process as well as by a number of new regulations leading to a more standardised audit work. It is clearly stressed by Eva Melzig, auditor of KPMG, that the standardisation is based on clients' increased IT focus as they rely on IT systems and spend huge amounts of money in valuation systems. Speaking about the perspective of public listed companies, the majority of interviewees claimed that the standardisation of the audit process is caused due to more governmental regulations. Only interviewee 4 took the view that the audit process will become more innovative considering the different views of a number of auditors.

In order to achieve enhanced statutory audits, stricter requirements for audit reports were established, but differentiating between non-PIEs and PIEs. These requirements comprise, among others, stricter regulations on independence, the provision of more detailed information about the audited financial statements and the competency enhancement of capable authorities responsible for the auditors' supervision. Moreover, statutory auditors and audit firms of public listed companies are required to apply stricter additional requirements, including the providing of a more detailed audit report, data about the audit performance, the reduction of fees charged for NAS, the implementation of mandatory firm rotation and the reinforcement of the audit committee's role as well as the development of regular communication between statutory auditor or audit firm of the public listed company and the supervisor of that client company (EC, 2016). An analysis of my interviews revealed that all auditors questioned are aware of the fact that the new regulation triggers changes in the audit report as well as in the methodology. On the contrary, the interviewees representing public listed companies do not seem to be aware of the impact of the new EU regulation on the audit report. They did not agree with the auditors' opinion by stating that the new regulation of audit firm rotation will not have an impact on the audit report and audit methodology itself.

Furthermore, in connection with the new regulation, I tried to figure out in which way the preparation of audits and the audit itself will be influenced. Both groups interviewed, the auditors as well as the representatives of the public listed companies shared the opinion that the preparation for the audit and also the audit itself will become more time-consuming. When expressed as a percentage, the majority of the respondents talked about more than 20 per cent up to 40 per cent. The reason given was the increased need for explanation and documentation work of the clients' business, meaning increased work for clients to explain their strategies and operations to new auditors and more work for auditors in terms of understanding the clients' business. Eva Melzig, auditor of KPMG, clearly stated that the whole process is complex and is connected with lots of administration work and negotiations particularly in the first year of the engagement.

#### 5.6.4 Perceived impact on the audit market

Speaking about the impact on the audit market, respondents claimed that the market will become more dynamic due to the new regulation. One reason is the ban of the 'Big 4 only' clauses leading to a division of the audit market among a number of audit firms. Another aspect

that was mentioned is that small audit firms will have greater opportunities because of the implementation of the 'black list' and the joint-audit mandates. This fact was explicitly stated by Eva Melzig and auditor Y. According to my research, all respondents possess knowledge about the new regulation to some degree. Given the fact that the European Commission tries, among other goals, to create a more dynamic audit market, the ban of the 'Big 4 only' clauses could trigger a division of the audit market, hence leading to excessive opportunities for small audit firms which are not part of the big networks (EC, 2016).

Additionally, the auditors expressed in the interview that the Swedish audit market will be affected immensely due to the complexity of the clients' requirements and the extensive planning process when it comes to tendering. On the contrary, respondents representing public listed companies do not expect any change, but they seem to be lacking in enough knowledge about the Swedish audit industry. The exception was interviewee 4 who argued that the audit quality will be improved due to increased independence.

#### 5.6.5 General opinion about auditor rotation and its impact on audit quality

The results of my qualitative research from the perspective of auditors show that audit partner rotation positively impacts audit quality. According to them, long-term auditor-client relationship does not necessarily increase audit quality, but rather tends to decline the quality due to the risk that an auditor gets too involved in the clients' company, thereby harming auditor independence and objectivity. However, when it comes to audit firm rotation they raise their concerns regarding the sense of it as it is believed that a different person looks differently on the clients' company, hence there is no need to change the audit firm and it is enough to change the audit partner. Further, they pointed out that audit firm rotation is connected with immensely growing tendering costs and more time effort for preparing those tenders. Whereas interviewees representing public listed companies share different views, with three companies being in favour of audit firm rotation and two of the interviewed companies are absolutely against it. Those companies favouring the audit firm rotation defended their points of view with arguments regarding the lack of auditor independence and objectivity caused by a lengthy relationship between auditor and client, and that audit firm rotation will provide a fresh look and thus positively influencing audit quality. On the contrary, public listed companies not supporting this regulation stated that it is associated with high costs and lots of explanation work. One opponent added that a long-term relationship provides more knowledge and understanding between auditor and client, whereby the client benefits from the professional feedback of an experienced auditor, hence aiming to keep the auditor as long as possible.

## 6 Conclusions

Chapter six starts with the general conclusions drawn from this study which are directly related to the research question and the purpose, aiming to answer the research question. Next, the theoretical contributions along with societal considerations are explained in detail. Lastly, suggestions for further research in this area are specified.

### 6.1 General conclusions

The main purpose of my study was to gain a deeper understanding of how auditor rotation, in particular audit firm rotation, impacts audit quality as it is perceived by audit firms and public listed companies located in Sweden, meaning to investigate whether rotation increases or lowers audit quality. This led to my research questions: 1. “How does auditor rotation affect audit quality perceived by audit companies based in Sweden?” and 2. “How does auditor rotation affect audit quality perceived by public listed companies based in Sweden?”. For this reason, I identified all associated factors related to auditor rotation and audit quality in my literature search, and based on this, I collected my empirical evidence, analysed it and conclude it in this chapter.

The findings of my qualitative study showed that the new EU regulation of audit firm rotation will result in a more effective auditing process as auditors are exposed to higher pressure to work correctly, otherwise their reputation could be harmed, and also audit quality will be enhanced, especially considering the fresh views each new auditor will bring to the company audited. Further, the audit process will become more standardised because of an increased number of IT systems contributing to a more simplified and faster audit process as well as additional governmental regulations. The preparation for the audit process and the audit itself will become more time-consuming, the reasons are a large demand for clarification and more administration work for both parties included. Additionally, auditor rotation is connected with heavy expenses for client firms’ due to high start-up costs for each new engagement, but also audit firms are exposed to higher expenses triggered by increased tendering costs.

The results further display that, although rotation provides a fresh look to the financial statements neither the auditors’ independence and objectivity nor the trustworthiness of the audited financial statements will be enhanced according to the majority of the respondents. Also, the likelihood to detect material misstatements will not be increased due to rotation as in-depth knowledge about the clients’ industry gained through a long-term tenure is required to successfully conduct an audit and to improve audit quality. A long-term auditor-client relationship leads to a constant level of audit quality caused by the same working style during the whole engagement, whereby the fundamentals for the consistent quality are procedures, techniques and tools used during the audit process. Nevertheless, findings suggest that audit quality saturates after a period of seven to ten years, and the audit quality would be enhanced due to periodic audit rotation. During the initial years of an audit engagement, audit quality is perceived as low, but the engagement is taken up by an auditor with eagerness and enthusiasm, thus audit quality is likely to increase in the following years.

Concerning overcoming the agency problem through auditor rotation, I conclude that an auditor is not the solution to the problem between the management and the owners. As far as public listed companies are considered, auditors either have a relationship with the client’s management or the audit committee, and infrequently meet or interact with the owners of the client company. The appointment of an auditor is made on the basis of several factors, like the

combination between quality and costs, the auditor's industry knowledge of the client and the creativity to solve problems. For public listed companies, the brand-name and the size of the audit firm matters when selecting an auditor as these well-known firms are believed to offer high audit quality due to their reputation, resources and expertise. Hence, client companies are willing to pay higher fees for the industry specialisation and the expected enhanced audit quality. Both groups interviewed regarded the appointment of an auditor through a regulator as illogical considering that the relationship between auditor and client is based on trust, therefore, an external person should not interfere and might have lacking knowledge in view of the auditor's experience in the client's industry, which is likely to lead to audit failures. Other reasons for audit failures could be poor planning by the auditor, insufficient information from the clients' side either due to error or fraud.

In Sweden, auditors are prohibited to provide acquisition and accounting services as non-audit services to the same client company they have an audit engagement with, but they are allowed to offer other NAS to their clients such as taxation services, consultancy and advice regarding mergers. However, the implementation of the so called 'black list' has led to further restrictions, which is favoured by most respondents, as it is believed that audit and NAS need to be separated in order to ensure auditor's independence and thus high audit quality. Auditors in Sweden must follow professional ethics on the firm-level and on the state-level, such as ISA and FAR. In the auditor-client relationship, the auditor is subjected to discussions concerning audit opinion which may result in modified opinions because of justifications or sympathy involved as far as the nature or complexity of the problem is affected.

On the one hand, joint-audits are perceived as advantageous for client companies since several auditors look at their financial statements from different angles thus improving audit quality, whilst on the other hand, audit efficiency is adversely impacted as audit firms have to deal with extra work. However, the implementation of audit firm rotation, joint-audits, the 'black list' and the ban of the 'Big 4 only' clauses triggers a more dynamic audit market providing great opportunities for small companies. Also, the Swedish market will be affected due to the complexity of clients and the extensive planning when it comes to tendering.

My study thus comes to the conclusion that the auditors interviewed are favouring audit partner rotation as they believe in its positive effect on audit quality due to the prevention of a too close relationship triggered by a long-term auditor-client relationship. However, they do not see an additional benefit from audit firm rotation since from their point of view audit partner rotation has already fulfilled the same purpose. CEOs and CFOs of public listed companies share different opinions concerning this topic. Some of them perceive auditor rotation is strengthening audit quality because of the fresh look brought by a new auditor and increased auditor independence, whereas the others believe that the new regulation is lowering audit quality due to the new auditor's lacking industry knowledge of the client. It is worth mentioning that other factors, like separation of NAS and audit, joint-audits, expertise and experience of the auditor, a detailed audit plan, providing of full information by the client and the appointment of the auditor by the client itself, have a positive impact on audit quality.

## 6.2 Theoretical contribution

Through my qualitative study I have made two separate theoretical contributions. Firstly, to my best knowledge this is the first study conducted in this specific field, and only focusing on Sweden. I tried to gain a deeper understanding of how auditors and CEOs and CFOs working in public listed companies perceive the impact of auditor rotation on audit quality, whether, in

their opinion, rotation either lowers or enhances audit quality. This study also contributes to existing literature by comparing with the perceptions of the research attendees regarding the impact of auditor rotation on audit quality, with a particular emphasis on audit firm rotation. Secondly, my study adds up to theory by providing detailed information about the new EU regulation implemented in the year 2016, and particularly its impact on the Swedish audit market and how it is perceived by professional market participants.

Considering that no attention has been paid in previous research on the perceptions of audit firms and public listed firms based in Sweden how audit firm rotation impacts audit quality, this study bridges the current gap in literature regarding this topic.

### 6.3 Societal contributions

My study contributes to society in various ways. Firstly, it provides comprehensive information about auditing and several factors influencing audit quality, which could be interesting for professional market participants. Secondly, auditors, PIEs and non-financial institutions are affected by the new EU regulation, hence my study can serve as an information guide about the new regulation, and particularly its impact on the Swedish market. Thirdly, small audit companies could profit from this study by examining the listed opportunities they will receive due to the new regulation. Fourthly, this study is beneficial for every person who is interested in auditing to get precise information about this topic.

### 6.4 Suggestions for further research

When searching for appropriate literature as well as during the collection of my primary data, I touched on several suggestions which have potential for further research concerning auditor rotation and audit quality. Keeping in mind that the frame of my study was restricted to public listed companies and audit companies located in Sweden, the investigation should be carried out and be replicated in other countries to test and verify the findings gained from it. Further, the same study could be replaced in a couple of years to figure out how this new regulation affected the Swedish audit market. Another interesting research topic in this context would be the comparison of the impact of audit firm rotation and audit partner rotation on audit quality. As the new EU regulation of audit firm rotation is fairly new, I would suggest carrying out a more extensive study to figure out how all affected parties or a specific group of those affected thereby, perceive this new regulation. This study could either focus on the perceptions of companies based in a specific country or at a transnational level depending on the time frame and the required scope of the investigation. In connection with the new EU regulation an investigation about the benefits and drawbacks of joint-audits could be interesting. Further, a research about the separation of audit and non-audit services which contribute the major portion to audit firms' revenue stream, and its impact on audit quality could be taken up.

## 7 Quality criteria

Chapter seven deals with the quality criteria, and on if the previously presented study complies with them. All terms determining the quality of a qualitative research are explained as well as the evaluation of these quality criteria for this study.

### 7.1 Introduction to the quality criteria

According to Bryman & Bell (2011, p. 395), there are two main quality criteria, namely trustworthiness and authenticity which can be used to evaluate qualitative studies. Additionally, trustworthiness can be subdivided into credibility, transferability, conformability and dependability (Bryman & Bell, 2011, p. 395). The subsequent sections explain how my research was enhanced based on these quality criteria.

#### 7.1.1 Credibility

Credibility requests the assurance that the study conducted is based on the principles of a good practice. It is also concerned if the reader perceives the authors' conclusions as reliable regarding to reality. Additionally, it deals with the possibility whether the study can be replicated easily and re-conducted in reality (Bryman & Bell, 2011, p. 396). Considering this, the credibility of my study can be evaluated as high. The reason for this lies in the fact that I used semi-structured interviews with open questions making it possible to ask clarifying questions based on the replies of the respondents. To further enhance the credibility, I verified my understanding of the received responses by summarising all interviews at the end of each telephone call. Thus, each respondent got the opportunity to react and correct potential misunderstandings.

#### 7.1.2 Transferability

Transferability is the degree to which the findings of a research study can be applied to different situations (Bryman & Bell, 2011, p. 395). At the beginning of my study, I assumed that all interviewees will have different views and perspectives regarding my research topic and thus I perceived the transferability of my study as low. However, when writing down the findings, I realized that most responses are quite similar just expressed in diverse ways. Therefore, I assess the transferability of my research as high, considering that I received similar answers even though the interviewees worked in different firms and industries.

#### 7.1.3 Conformability

Conformability is a criterion that evaluates the objectivity of a research study (Bryman & Bell, 2011, p. 395). In my study, I used open questions to enable my respondents to express themselves openly. Furthermore, I tried to avoid the use of leading questions which could manipulate the answers of my interviewees and adversely impact my findings. Finally, I made sure to take advantage of information and opinions anchored in theories or in responses gathered from my interviews in the most objective manner, and by this avoid including my opinion.

#### 7.1.4 Dependability

Dependability is the assurance that all phases of the research process, including problem formulation, selection of research participants, interview transcripts and data analysis are recorded entirely, thus showing the reader that the whole process goes along with orderly



procedures (Bryman & Bell, 2011, p. 398). In order to ensure this, I documented all different steps of my research by starting with the introduction over interview records until the transcription of them. Additionally, I kept all diverse versions of my study and thus, the dependability of my study assessed as high.

#### 7.1.5 Authenticity

Authenticity plays a crucial role while debating the quality criteria of a research study. Bryman and Bell (2011, p. 399) argued that in order to warrant fairness, all respondents must present distinctive views from different standpoints. Considering this aspect, I tried to ensure the presentation of different standpoints from my respondents during my thesis. I aimed to dedicate sufficient and equal space for diverse opinions and viewpoints expressed by my interviewees.

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# APPENDIX

## Appendix 1: Interview guide – public listed companies

### Background Information

1. Since when is your auditor already engaged?
2. What was the main reason to change to the current auditor?
3. Does your company have a policy for changing auditors?
4. How important is the expected audit quality for your auditor decision?
5. How do you perceive the audit quality of your current auditor?
6. What are the main areas of the audit opinion you receive?
7. Did your company have to report a material misstatement within the past 5 years?
8. The European Commission is thinking about the appointment of an auditor through a regulator rather than by the client firm itself. What is your opinion about it?

### Auditor Rotation and its impact on Audit Quality

9. How will the independence be affected through rotation?
10. How will the objectivity be affected since the relationship between management and auditors will be more formal?
11. How will the trustworthiness of information be affected due to increased independence of the auditors?
12. How will the rotation affect the auditor's likelihood to detect more infringements in the accounting system?
13. How will the rotation affect the probability of finding frauds?
14. Do you think the auditing costs will decline/ increase due to auditor rotation? Why?
15. How important are the costs of auditing for your auditor decision?
16. Have you perceived a better audit quality the longer your audit company has conducted your audits?
17. Studies found, that the probability to detect material misstatements is lower in the initial years of the audit engagement due to a lack of understanding the client's business. What do you think about it?
18. What are the reasons for audit failure?
19. How do audit firm size and brand-name impact the audit quality?
20. Do you think an auditor working in a large audit company, assuming that those provide higher audit quality, is entitled to charge higher fees?
21. Is your auditing company also engaged in tax consulting or other non-audit services?

22. How will the audit quality be affected if the audit company is also engaged in non-auditing services?
23. Do you think the rotation will solve the agency problem between owners and management? Why?
24. What preparations are you conducting to deal with auditor rotation?
25. What rotation period is adequate from your point of view?
26. What is your general opinion about a joint audit mandate? Do you think it is beneficial for the audit firm and the client firm? Why? Why not?
27. Do you think there will be more pressure to increase effectiveness of the auditing process? Why?
28. What do you think? Will the auditing process become more standardised or innovative due to rotation?
29. What changes will occur for the audit report and the audit methodology under rotation?
30. What material changes in the preparation for the audit will companies have to cope with (e.g. more documentation)?
31. Do you think that the preparation for the audit will be more time-consuming for the companies involved?
32. +10%/ +20%/ more than 20%
33. Do you think the audit itself will be more time-consuming through rotation?
34. +10%/ +20%/ more than 20%
35. Do you think that auditor rotation will trigger a more dynamic audit market through increased competition in the auditing field? Why?
36. What changes will this new regulation bring to the auditing industry infrastructure in Sweden?
37. Overall, what is your general opinion about auditor rotation and its impact on audit quality?

## Appendix 2: Interview guide – audit companies

### Background information

1. What is the size of your company?
2. Generally, how long is the average relationship with your clients?
3. In your relationship with your clients, have you ever been asked or sympathised by a client to modify your audit opinion?
4. The European Commission is thinking about the appointment of an auditor through a regulator rather than by the client firm itself. What is your opinion about it?

### Auditor Rotation and its impact on Audit Quality

5. How will the independence be affected through rotation?
6. How will the objectivity be affected since the relationship between management and auditors will be more formal?
7. How will the trustworthiness of information be affected due to increased independence of the auditors?
8. How will the rotation affect the auditor's likelihood to detect more infringements in the accounting system?
9. How will the rotation affect the probability of finding frauds?
10. Do you think the auditing costs will decline/ increase due to auditor rotation? Why?
11. Do you think that a long-term auditor-client relationship results in a constant level of audit quality over the years?
12. Studies found, that the probability to detect material misstatements is lower in the initial years of the audit engagement due to a lack of understanding the client's business. What do you think about it?
13. What are the reasons for audit failure?
14. How do audit firm size and brand-name impact the audit quality?
15. Do you think an auditor working in a large audit company, assuming that those provide higher audit quality, is entitled to charge higher fees?
16. How will the audit quality be affected if the audit company is also engaged in non-auditing services?
17. Do you think rotation will solve the agency problem between owners and management? Why?
18. What preparations are you conducting to deal with auditor rotation?
19. What rotation period is adequate from your point of view?
20. What is your general opinion about a joint audit mandate? Do you think it is beneficial for the audit firm and the client firm? Why? Why not?



21. Do you think there will be more pressure to increase effectiveness of the auditing process? Why?
22. What do you think? Will the auditing process become more standardised or innovative due to rotation?
23. What changes will occur for the audit report and audit methodology under rotation?
24. What material changes in the preparation for the audit will companies have to cope with (e.g. more documentation)?
25. Do you think that the preparation for the audit will be more time-consuming for the companies involved?  
+10%/ +20%/ more than 20%
26. Do you think the audit itself will be more time-consuming through rotation?  
+10%/ +20%/ more than 20%
27. Do you think that auditor rotation will trigger a more dynamic audit market through increased competition in the auditing field? Why?
28. What changes will this new regulation bring to the auditing industry infrastructure in Sweden?
29. Overall, what is your general opinion about auditor rotation and its impact on audit quality?

## Appendix 3: Email to public listed companies and to audit companies

Dear ...,

My name is Sonja and I am a Master Student in Accounting and Auditing at Umea University, currently writing my Master thesis with the title:

“How does audit firm rotation affect the audit quality perceived by audit firms and public listed companies in Sweden?”

On 17 June 2016 the European Union implemented a new regulation – requiring public listed companies to rotate their audit firm after a predetermined period of 10 financial years. Also, Sweden is obligated to implement this new regulation, therefore I would like to investigate, with the help of a qualitative study, how public listed companies and audit firms in Sweden perceive the impact of audit firm rotation on audit quality.

Hence, I would like to ask you whether you are willing to participate in an interview either via phone or Skype. The interviews will take place between 1 and 17 May 2017.

Your help would be appreciated.

Looking forward to hearing from you.

Many Thanks and Kind Regards,  
Sonja Oberleitner



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