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Legitimizing Mandatory Rotation

A glimpse into mandatory rotation and its expected implications in Germany and Sweden

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Abstract

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Title: Legitimizing Mandatory Rotation – A glimpse into mandatory rotation and its expected implications in Germany and Sweden

Background and Problem: In the aftermath of the global financial crisis and a series of corporate scandals in recent years legislators have discussed mandatory audit firm rotation as a mean to ensure auditor independence and to promote audit quality. New regulations have been pushed forward by the European Commission and a rotation requirement had to be implemented by all EU member states until June 2016. Yet, opinions about mandatory audit firm rotation are rather split and there has been significant opposition against the regulation. According to legitimacy theory a legitimacy gap occurs, if society's expectations and an organization's activities are not aligned. The discourse on mandatory rotation can therefore be seen as a debate about the legitimacy of auditing itself.

Purpose: This study aims to investigate how legitimacy is created in Sweden and Germany around the recently implemented regulation on mandatory rotation of audit firms by analysing the arguments made in the debate on mandatory rotation. It aims to provide a better understanding of the regulation and to indicate the implications of mandatory rotation on auditor independence, audit quality and competition as seen by market participants and practitioners in Germany and Sweden.

Research Design: In order to address the research problem a qualitative study was conducted. It firstly comprises a document analysis of a series of EU documents together with a selection of comment letters from affected third parties from Germany and Sweden. This was then enriched with four interviews with practitioners in Sweden. The study therefore relies on Whittle et al.'s (2014) framework regarding discursive strategies to illustrate the arguments made in the discourse on mandatory rotation.

Discussion and Conclusion: Mandatory rotation has sparked a fierce debate about its implications for auditors and businesses. Contrary to the objectives of the European Commission, this study suggests that it might not achieve its three main objectives in Germany and Sweden as the findings on the one hand highlight a tendency to question the positive effect on the independence in mind and on the other hand emphasize a potentially negative effect on competition in both countries. However, independence in appearance is increasing with the new regulations and only future research will reveal the cost implications of mandatory rotation, which might ultimately decide about the success of the reform.

Keywords: Mandatory Rotation, EU audit reform, Legitimacy, Auditing, Discursive Strategies

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List of Abbreviations

CSR	Corporate Social Responsibility
DAI	German Institute for Share Promotion
DGB	German Trade Union Confederation
EEA	European Economic Area
EC	European Commission
EU	European Union
EY	Ernst & Young
FAR	Institute for the Accountancy Profession in Sweden
GAO	Government Accountability Office
IAASB	International Auditing and Assurance Standards Board
IDW	Institute of Public Auditors in Germany
IESBA	International Ethics Standards Board for Accountants
NAS	Non-Audit Services
NGO	Non-Governmental Organization
PCAOB	Public Company Accounting Oversight Board
PIE	Public-Interest Entity
PWC	PricewaterhouseCoopers International
SRF	The Association of Swedish Accounting Consultants
U.S.	United States of America

1. Introduction

The opening section presents the theme and motivation for this thesis, accompanied by an overview about the purpose of the study. It finishes with a brief outline of the structure of the study.

1.1 Background

Auditing has always been a mean to enforce public expectations about fair competition and accountability of individual market participants. The actual term “auditing” can be derived from the Latin word for to hear “audire”, and refers to auditors which listen to the firm's' financial information in order to understand and identify potential dissonances in these statements. This task has lifted auditors to a central element in the modern business world, since they not only assure the public of corporate compliance with the accounting regulations but also act as a link between management and investors.

However, repeated corporate scandals and the global financial crisis have damaged the impression of auditing being an effective instrument to ensure corporate compliance. Multinational firms rely on four large audit firms, which shields those firms nearly completely from the risk of losing business as competition is rather low in such a thin market. Being involved in recurring accounting misbehaviour therefore not firmly harms the auditors' business, especially if competitors are ensnared in scandals as well. Audit firms have been constantly involved in the most prominent scandals and ever since the Enron scandal and the subsequent breakup of Arthur Andersen regulators have called for a stricter monitoring of audit firms in order to ensure and enhance audit quality. Intensified by the role of auditing in the global financial crisis 2008/2009 they have pushed to implement novel ways to improve audit quality.

The discussion about the actions and failures of auditors bears a great risk for the audit profession as it corrodes the basic essence of an auditor's work: the perception of auditing as an effective mean to overcome the agency problem. It raises questions about the legitimacy of an audit itself as well as about the auditors' capability to act as a sufficient safeguard against corporate misbehaviour. It is therefore in the professions own interest to guarantee that auditing appears legitimate to the public and to ensure investors and the general public of its importance for business and society.

Audit quality can be expressed by the probability that the auditor will reveal and report a breach in the firm's financial statements (DeAngelo, 1981). Besides the ability and knowledge to detect accounting misconduct, reporting and demanding remedy is a key factor of a thorough and efficient audit process. Hence it is essential for auditors to maintain independence, which can be conceptualized as the ability to make decisions without interference by other parties. This has been acknowledged by professional bodies like the IAASB, which have incorporated auditor independence as a central element in their framework to preserve and enhance audit quality (IAASB, 2014).

Mandatory audit firm rotation (hereafter mandatory rotation) has been frequently discussed as one mean to ensure auditor independence. According to its proponents, it will reduce the risk of an auditor becoming overly close and dependent on a particular client and strengthen the position of the auditor.

The U.S. started by introducing the Sarbanes-Oxley Act in the aftermath of the Enron scandal, which imposed mandatory audit partner rotation as a mean to enhance audit quality (U.S., 2002). However, calls for further restrictions and mandatory rotation have petered out in the U.S.. In 2013, the U.S. Congress decided to prohibit the implementation of mandatory rotation on the basis of a longstanding investigation of the implications by the public company accounting oversight board (Tysiac, 2013).

In contrast, the European Commission agreed at the same time to tighten audit regulations, which included amongst others the introduction of mandatory rotation. EU regulation No. 537/2014 and Directive 56/2014 had to be implemented into national law by all member states until June 2016 even though the member states were able to modify the statutes to some extent in order to acknowledge own convictions (EU, 2014). Besides mandatory rotation further rules regarding the prohibition of non-audit-services (NAS) and the role of audit committees were included in the new regulation. Germany and Sweden adopted the EU-directives in spring 2016 and the so called audit package came into force from the 17th June of 2016 in both countries. Both governments however, did not tighten the EU proposals for the maximum tenure. In general, listed companies are now forced to change their audit firm after ten years, if they don't meet specific requirements that allow them to keep their firm up to 24 years. Mandatory rotation has thus reached Germany and Sweden.

1.2 Motivation for the study

The debate within academics, business and politics about mandatory rotation as a mean to enhance auditor independence has been and still is constant and lively (e.g. Gerakos & Syverson, 2015; Cameran, Prencipe & Trombetta, 2016). Opinions about the effect and the benefit of a rotation regime are markedly at variance, not only between researchers but also among legal institutions. While the U.S. and several smaller countries have discarded mandatory rotation on the basis of an understanding that the audit profession itself has enough incentives to maintain independence, the EU has imposed mandatory rotation in order to increase competition and ensure a sufficient level of independence.

“In order to address the familiarity threat and therefore reinforce the independence of statutory auditors and audit firms, it is important to establish a maximum duration of the audit engagement.” (EC, 2014)

The European Commission seems to be convinced that limiting the audit tenure by law will hence increase the confidence of investors and consumers in the accuracy of financial statements. One can argue that the EU questions the current legitimacy of audit practices and aims to increase the legitimacy for the audit profession itself by implementing new regulations.

Although several researchers support the proponents' arguments that mandatory rotation increases audit quality by reinforcing professional scepticism and limits incentives to give in to demands of the management (e.g. Cameran et al., 2016; Dopuch, King & Schwartz, 2001; Gietzmann & Sen, 2002; Wang & Tuttle, 2009) it is controversial if mandatory rotation in fact can positively influence audit quality (Johnson, Khurana & Reynolds, 2002; Ruiz-Barbadillo, Gómez-Aguilar & Carrera, 2009).

Business associations, investor groups and audit representatives consulted during the investigations or drafting processes both in the U.S. and Europe opposed to an overwhelming extent the implementation of mandatory rotation (EC, 2011b). Their arguments are mostly based on missing actual evidence for positive implications of a rotation regime. These arguments are in line with results from South Korea and Spain, where previously imposed mandatory rotation had no positive consequences for audit quality regarding to two empirical studies (Ruiz-Barbadillo et al., 2009; Kwon, Lim & Simnett, 2014).

The markedly different viewpoints of practitioners on the one side and the commission on the other side reveal that the EU audit reform is not only about introducing a new regulation. Power (2003) argues:

“In order to generate trust in financial statements, audit practice must generate trust in itself.” (p.380)

The new regulation questions the legitimacy of current audit practices and the auditors’ willingness and ability to fulfil their envisaged role in society. It is therefore interesting to analyse the arguments made during the debate on mandatory rotation and to illustrate how legitimacy is created for and against the new regulation and by this try to establish a better understanding for the potential implications of the new standards.

1.3 Purpose

The main purpose of this study is to investigate how legitimacy is created in Sweden and Germany around the recently implemented regulation on mandatory rotation of audit firms. I choose Sweden and Germany, because both countries have rather similar characteristics in terms of audit market, accounting tradition (Öhman & Wallerstedt, 2012) and public awareness for fraud and corruption (Transparency International, 2017). They both have a strong legal enforcement (Leuz et al., 2003) and represent powerful economies. Thus, they build a good foundation to examine the debate about the new regulation.

Furthermore, the study aims to provide a better understanding of the mandatory rotation regulation and to indicate the implications of mandatory rotation on auditor independence, audit quality and competition as seen by market participants and practitioners in Germany and Sweden. The study will focus on mandatory rotation, prohibition of non-audit services and auditor independence as these arguably have been the most contested issues of the EU audit reform.

To obtain insights in the process of how legitimacy is created around the new regulation I analyse a series of EU documents as well as a variety of comment letters towards the regulation written by respondents in Sweden and Germany. I therefore rely on legitimacy theory and in particular on Whittle, Carter & Mueller’s (2014) framework regarding discursive strategies. This is done in order to illustrate which arguments are used throughout the discursive processes regarding the new requirements and how the different actors attempt to create trust, credibility and understanding for their arguments. The framework distinguishes between a variety of strategies used to de- and re-legitimize a certain practice or institution and I aim to delineate how those strategies are used in the discourse on mandatory rotation. I collect further insights about the viewpoints of market participants through interviews with

practitioners in Sweden, which accompany the findings from the document study and offer a verification of the results and additional information about the potential implications of the reform as seen by them.

The arguments made in the debate build the foundation for the conflict of creating and protecting legitimacy for a) maintaining the previous practice and b) the implementation of a new practice. They are highlighted within this study and related to previous studies about the effect of mandatory rotation as well as to previous research about the production of legitimacy in the field of auditing. Nevertheless, the main purpose is to examine how legitimacy is created during the discourse on mandatory rotation and to examine the arguments made in the debate. This will increase the understanding for the process of managing legitimacy as well as for the implications of the new regulations on auditor independence and audit quality in Germany and Sweden.

1.4 Outline of the study

This study consists of six chapters. The introduction chapter presents the problem statement as well as the motivation for the study and its purpose. This section is followed by the frame of reference in chapter two. It consists of the theoretical framework applied within the study and provides the background information about the EU regulation, the institutional context of the audit landscape in Germany and Sweden as well as about the concepts of mandatory rotation and auditor independence. Chapter three then describes the methods used throughout this study and outlines the research design and research approach. It is followed by the empirical findings and analysis chapters, which present the findings from the document study and the interviews and relate them to the theoretical framework as well as the previous literature on mandatory rotation. The thesis finishes with the concluding discussion in chapter six, which presents and summarizes the findings from the study. Suggestions for future research are also given in the final chapter.



Figure 1: Outline of the study

2. Frame of Reference

This section presents the theoretical framework used in this study and delineates the institutional background for the new regulation as well as the regulation itself. It further presents previous literature on mandatory rotation and links mandatory rotation to auditor independence.

2.1 Legitimacy theory

Legitimacy theory claims that organizations are continuously seeking to ensure that they are perceived as operating within the bounds and norms of society. It means that organizations constantly attempt to make sure that their activities are perceived as being legitimate by individuals, investors, and society in general (Deegan & Unerman, 2011). The values, norms and boundaries in which the organization is operating are not considered as fixed, but as a dynamic constantly changing system, which requires organizations to adapt to the changing outside perceptions. Legitimacy has often been defined by researchers, but during this study it is referred to Suchman's (1995) widely accepted definition of:

“a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions.” (p.574)

In general, legitimacy theory relies upon the notion of an implicit social contract between the organization and society. This notion of a social contract is difficult to define, however, it can be used to illustrate the multiple implicit and explicit expectations society has towards the organization how it should operate and pursue its activities (Deegan & Unerman, 2011). Moving forward from the traditional perspective of profit maximization as the optimal measure of corporate performance, the rise in social expectations has led to today's notion of organizations being responsible for a multitude of social consequences which arise from their actions (Deegan & Unermann, 2011).

Failure to meet the expectations of the society and the perception that an organization is not responsive for instance to the social consequences of their activities can lead to a decline in the perceived legitimacy, which in turn can result in penalties imposed through society that can take the form of financial, legal and economical restrictions or punishment by the public (Deegan & Unermann, 2011). It can result in a scenario, where individuals and the public perceive the implicit social contract on which both sides had previously agreed on as not binding anymore as the organization is not willing to operate according to the values cherished by society. This then can ultimately threaten the survival of the organization itself. It is therefore in the own interest of each organization to constantly operate within the bounds and norms of society and try to align with society's expectations (Lanis & Richardson, 2012).

Organizations are thus willing to take a multitude of actions to ensure that their activities are perceived to be legitimate by not only investors but all other stakeholders and society. According to Dowling & Pfeiffer (1975) organizations are willing to achieve congruence between *“the social values associated with or implied by their activities and the norms of acceptable behavior in the larger social system of which they are a part.”* (p.122). The concept of legitimacy is not a concept of static, it refers more to a perception that the social expectations and values which create the norms and boundaries for an

organization are constantly changing and moving. Organizations therefore are continuously under pressure to adapt to the changing environment and maintain or defend the legitimacy of their operations.

2.1.1 Legitimation strategies

The perception of legitimacy as an implicit social contract between society and organizations that is constantly changing leads to the understanding that organizations can alter and manage their perceived legitimacy by actively adjusting their values and the expectations towards their activities. Lindblom (1994) for example presents four alternative types of legitimation strategies that organizations are able to use in order to manage their legitimacy:

- Inform society about the organization's intentions
- Change society's perceptions towards the organization
- Distract attention away from the issue of concern by highlighting other issues
- Adjust society's expectations about the organization's performance

Based on the assumption that there is a relatively high level of managerial control over the legitimation process, Lindblom (1994) argues that the ability to manage legitimacy especially through voluntary disclosures is therefore dependent on successful communication to and with society.

In a similar way Suchman (1995) argues that the choice of legitimation strategies will differ depending on the particular purpose of the organization and thereby links legitimation strategies with the objectives of the organizational response (O'Donovan, 2002). In a first step, Suchman distinguishes between three broad types of legitimacy: pragmatic, moral and cognitive legitimacy. Pragmatic legitimacy is based on the self-interest of the organization's closest audiences and can be explained as a sort of exchange legitimacy, while moral legitimacy is based on the evaluation whether a certain activity is seen as the correct thing to do bearing the social values in mind. Cognitive legitimacy in turn is based on cognition and refers to broader taken-for-granted values that decide about the legitimacy of an activity, independent of a positive or negative evaluation (Suchman, 1995). While cognitive legitimacy is based on taken-for-granted values that are very difficult to change, moral and pragmatic legitimacy can be influenced through open discourse. In a second step, Suchman then identifies the legitimation strategies outlined below:

	Gain	Maintain	Repair
General	<ul style="list-style-type: none"> • Select, conform to and manipulate environment 	<ul style="list-style-type: none"> • Perceive change • Protect accomplishments 	<ul style="list-style-type: none"> • Normalize • Restructure • Don't panic
Pragmatic	<ul style="list-style-type: none"> • Conform to demands • Select markets • Advertise 	<ul style="list-style-type: none"> • Monitor tastes • Protect exchanges 	<ul style="list-style-type: none"> • Deny • Create monitors
Moral	<ul style="list-style-type: none"> • Conform to ideals • Select domain • Persuade 	<ul style="list-style-type: none"> • Monitor ethics • Protect propriety 	<ul style="list-style-type: none"> • Excuse/Justify • Disassociate

Cognitive	<ul style="list-style-type: none"> • Conform to models • Select labels • Institutionalize 	<ul style="list-style-type: none"> • Monitor outlooks • Protect assumptions 	<ul style="list-style-type: none"> • Explain
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Table 1: Legitimation strategies according to Suchman (1995) [original in more detail]

Discursive strategies have therefore been another field of interest for researchers in order to identify how organizations react to issues regarding the organizations' perceived legitimacy and how legitimacy is achieved and maintained (Suddaby & Greenwood, 2005; Vaara & Monin, 2010). Simply spoken, discursive strategies refer to how institutions use discourse to appear legitimate in order to ensure that they achieve their organizational goals (Whittle et al., 2014). Discursive processes play an important role in creating favourable positions during a perceived transformation of socially accepted norms and also during institutional change and the creation of new organizational forms (Suddaby & Greenwood, 2005; Whittle et al., 2014). In the same context Vaara, Tienari & Laurila (2006) argue that discourse is a key medium for the de-legitimation of institutions in the face of questioned conduct.

Based on this understanding and grounded in ethnomethodologically inspired approaches Whittle et al. (2014) have developed a theoretical framework that shows a variety of discursive strategies used in the conflict of de- and re-legitimizing organizational activities. Ethnomethodology is the study of the practices used in the daily life through which social order is accomplished (Bryman & Bell, 2011).

De-legitimation refers to the process of questioning the legitimacy of a certain activity or institution and within their framework Whittle et al. (2014) have identified three different discursive strategies to undermine the legitimacy through discursive statements. Stake attribution refers to ascribing an illegitimate interest to others and thereby attributing a certain stake to them. In order to highlight the scepticism towards certain statements stake interrogation is used to question the objective of the other party and to uncover a potentially hidden interest or stake. The last strategy is stake misalignment which portrays an individual or group as not aligned with a legitimate set of interests. (Whittle et al., 2014)

In contrast, re-legitimation refers to the process of restoring or maintaining the legitimacy of an institution that is under pressure of de-legitimation threats. Here, the framework depicts four strategies. Stake inoculation refers to the process of denying or downplaying alleged misbehaviour to counter threats towards the legitimacy of the own activities, while stake alignment is linked to the process of claiming to be aligned with the legitimate interest of the other party or wider society. The third strategy, stake confession is basically the reverse of stake inoculation. It refers to the process of admitting to have a certain stake in order to avoid obvious misinformation or further scepticism among the public. Lastly, stake transcendence refers to people claiming to transcend any self-interest through being attached to a higher value or motive, which is in particular observable in the case of professions. (Whittle et al., 2014)

The framework can be used to analyse statements made in a discursive process with regard to how legitimacy is created during that process, on which perceptions is drawn on and how are the arguments presented that create an understanding for a particular position. It is summarized in the following table:

De-legitimation	
Stake attribution	The discursive process of ascribing (illegitimate) interests, stake and motive to other individuals or groups.
Stake interrogation	The discursive process of questioning the legitimacy of the interests, stake and motive of an individual or group.
Stake misalignment	The discursive process of claiming that an individual or group is not aligned with a legitimate set of interests
Re-legitimation	
Stake inoculation	The discursive process through which actors deny, or down-play, the notion that they have an illegitimate stake, interest or motive in a particular argument or course of action.
Stake confession	The discursive process through which actors admit or “confess” to having a particular stake, interest or motive.
Stake alignment	The discursive process through which actors claim to share, or align with, the (legitimate) interests of certain others.
Stake transcendence	The discursive process through which actors claim to transcend self-interest through attachment to a certain higher norm, value or ideal.

Table 2: Definitions of discursive strategies (Whittle et al., 2014)

The framework aims to explain the processes by which legitimacy is established and by which expectations and perceptions are aligned. Legitimacy as a socially constructed sense of appropriateness (Suchman, 1995; Vaara & Monin, 2010) is possessed objectively but created subjectively (Suchman, 1995; O’Donovan, 2002). By analysing the arguments made by different actors in society during the discourse the subjective viewpoints can be conceptualized and a preliminary understanding of how legitimacy is created can be achieved.

2.1.2 Legitimacy and auditing

The legitimacy of auditing has become under extensive scrutiny by society in the last decade (Power, 2003). This is seen as a crucial issue for the field of auditing, as it relies to a great extent on its perceived legitimacy not only for its license to practice, but also in order to create credibility and trust amongst individuals, investors and the public. Maintaining legitimacy is thus of essential value to the audit profession (Power, 2003; Whittle et al., 2014).

The basic essence of an audit is that the audited entity enters into a contract with the auditor in order to receive an unqualified audit statement on its own financial statements. The underlying reason which motivates the auditee to allow an auditor to scrutinize the financial statements is the understanding that this will add legitimacy to its own activities and helps in being seen legitimate by investors and the public. Because it is often mandatory to contract an auditor and auditors are authorized by the government to pursue audits, the legitimacy of an audit arises in turn through the legitimacy of the audit profession itself. If auditors are perceived as non-legitimate, no legitimacy would be created through an audit. This emphasizes the legitimacy which is created through audit practices and processes that are

perceived as legitimate itself. In summary (Power, 2003):

“In order to generate trust in financial statements, audit practice must generate trust in itself.” (p.380)

Auditing thus on the one hand creates legitimacy for the audited entity, but on the other hand needs to create legitimacy for its own practices (Power, 2003). Auditing practices can be displayed as a self-regulating system based on various elements like professional standards, disciplinary systems and training standards that are interrelated and loosely coupled. Economic, regulatory or political pressure constantly challenges the legitimacy of auditing practices (Power, 2003).

According to legitimacy theory a legitimacy gap arises, if there is a deviation between society's expectations and an organization's activities. The legitimacy gap is the difference in how society expects the organization to pursue its activities and how the society perceives the organizational behaviour (O'Donovan, 2002).

I argue that the corporate scandals in the early 2000's and the recent global financial crisis have created or at least revealed such a legitimacy gap between society and multiple institutions involved in the crisis like banks, rating agencies and also the audit profession. According to Sikka (2009) the global financial crisis has raised multiple questions about auditing practices and the role of auditors within society. In consequence, several regulatory responses, among them mandatory rotation of audit firms, have been proposed and implemented in the European Union, arguably to address the apparent legitimacy gap.

Furthermore, I argue that the debate about mandatory rotation and auditor independence can be seen as a consequence of differing expectations and perceptions from society towards audit quality (FT View, 2017). Therefore, the debate on mandatory rotation is one part of the field of conflict about the legitimacy of the audit profession.

2.2 EU audit reform

Sparked by the alleged legitimacy gap the European Commission started a new initiative to scrutinize the role of auditors and to implement new measures to increase the stability of the financial markets in the following of the financial crisis 2008/2009. From their viewpoint there was a need for *“clarifying the role of the auditors and introducing more stringent rules for the audit sector aimed in particular at strengthening the independence of auditors”* (EC, 2011a). A green paper was published in late 2010, urging professional bodies, businesses and other stakeholders to provide their considerations. The green paper focused on how auditors affect the financial market stability and how to enhance auditor independence (EC, 2010). Its most prominent and debated points include the rotation of audit firms, a mandatory tendering process and the prohibition of certain non-audit services.

The green paper received considerably more responses than usual from a broad range of stakeholders, which can be seen as an indicator for the impact of the proposed measures on the market. Although according to the commission there was a general acceptance of the green paper, most of the responses were strongly opposing the proposed actions (EC, 2011b). Especially the Big Four firms as well as

investor associations and associations of businesses reacted negatively, highlighting the potential costs and a potential decline in audit quality through the proposed measures (EC, 2011b). Interestingly, at the same time American legislators also discussed the crisis of auditing and started a consultation process regarding a potential rotation regime (PCAOB, 2011a). The respondents in the U.S. were also mostly rejecting mandatory rotation and both, the debate as well as further implementation efforts were stifled by the decision of the U.S. Congress to prohibit any implementation of mandatory rotation (U.S., 2013).

Despite the opposition from most of the consulted parties, the European legislators pushed forward the regulation with some adjustments and the EU audit package passed the European Parliament in April 2014 (EU, 2014). It was highlighted as a significant mean to “*considerably improve audit quality across the European Union and will ensure that auditors are key contributors to economic and financial stability*” (EC, 2014). In short, the regulation contains the following key aspects (EC, 2014):

- **Mandatory rotation of audit firms of public-interest entities (PIEs)**

PIEs are required to change auditors after a maximum period of 10 years. Member states can choose to extend the period up to 10 more years if tenders are carried out, or 14 years in case of joint audits.

- **Prohibition of certain non-audit services to audited PIEs**

Audit firms are prohibited from providing certain non-audit services to the PIEs they audit, including tax advice and services linked to the financial and investment strategy of the audited entity.

- **Cap on the provision of non-audit services to PIEs**

A cap on the fees generated from non-audit services in relation to the audit fees is established.

The regulation on mandatory rotation is seen as the central element of the reform, because according to the commission it has the most significant influence on the audit market and audit practices. According to the commission the reform and mandatory rotation in particular shall achieve three main objectives:

- ensure and enhance audit quality
- reinforce and improve the independence and professional scepticism of auditors
- spur competition and make the top end of the audit market more dynamic.

2.2.1 Implementation of the EU audit reform in Germany and Sweden

The timeframe to transpose Directive 2014/56/EU and regulation No. 537/2014 into national legislation started on the 16th of April 2014, when the EU audit reform passed the European Parliament and Council. In order to ensure a smooth implementation all member states were given two years until the 17th June of 2016 to adjust their national laws and comply with the statutory EU requirements (EU, 2014). All member states were provided with an array of options to adjust individual details and aspects of the reform to their country specific convictions and characteristics.

In Germany the EU audit reform has been implemented into national law by vote in parliament on March 17th, 2016 (Deutscher Bundestag, 2016), while Sweden implemented it on May 18th, 2016 (Sveriges Riksdag, 2016). Both countries applied a thorough analysis of the reform with a domestic focus. In

Sweden for instance it followed a special in-depth study to assess and evaluate the implications on the domestic market. The arguments from that analysis were combined in the proposal of the new legislation (Prop. 2015/16:162) and continuously discussed during the process.

It is noteworthy to say that the Swedish auditing environment is closely resembling the German environment, except for a rather large discrepancy in size. Due a historically strong German predominance in academics and trade relations both countries have rather similar accounting landscapes and are well suited to be chosen as countries of interest in this study (Öhman & Wallerstedt, 2012).

Hence, both countries have also implemented the EU audit reform in a nearly exact manner with very slight deviations. They follow the European baseline to a great extent and deviate merely in a few points from the proposed European regulation. Interestingly, one of the options that was used by both countries and implemented in national law is linked to mandatory audit firm rotation. According to Article 17 of the EU regulation 537/2014 a statutory auditor or audit firm shall be appointed for at least one year but any (renewed) engagement shall not exceed a maximum duration of 10 years. Article 17 (4) then provides the option for member states to increase the maximum time period up to a) 20 years in case a public tendering process is conducted and b) 24 years in case of a joint audit arrangement. The minimum initial engagement period has been set in both countries to a minimum of one year and a maximum of four years. Both countries also decided to choose the option to extend the rotation period, meaning the regular rotation period for all PIE's will be 10 years, with the option to extend the period up to 20 years via a tender or up to 24 years via joint audit arrangements. However, both countries also adopted a two-tier approach for mandatory rotation and exclude banks and insurance companies from extending the rotation period after 10 years, while all other PIEs are able to use the option to extend their engagement with the same audit firm. Regarding audit partner rotation, Germany and Sweden maintain the current state of a seven-years rotation period and forgo the option to further tighten and shorten this timespan.

The table presented in appendix 4 illustrates how the key aspects of the EU regulation were transposed into German and Swedish law. It presents the main elements of the EU "baseline" regulation in the first column, the potential options for member states to adjust the regulation in the second column and in the last column the similar approaches from Germany and Sweden. It is observable from the table that both countries are not deviating from the EU baseline regulation to a great extent. Most possibilities to exercise an option are foregone. No further services are added to the list of prohibited non-audit services and certain valuation and tax services are permitted. This is in line with the conviction not to impose more stringent requirements on fee caps or add further requirements.

Nonetheless, on the one hand the options to extend the rotation period are applied, but on the other hand additional requirements for banks and insurance companies are implemented. Limiting the period for banks and insurance companies might result in more frequent changes of auditors in those sectors. In general, however, both countries have availed the opportunity to ease the rotation periods by

implementing the possibility to extend the engagement with a certain audit firm through conducting a tender process. The regulation will be applied for financial years starting after the 17th of June 2016.

2.2.2 Transposition in other member states

Although the timeframe to transpose the EU regulations into national law has ended in June 2016, not all 28 member states have completed the transposition process yet. Up to date five states have not finished the process or have not communicated transposition measures and the European Commission commenced with infringement proceedings (EC, 2016). The figure below illustrates the current status of the transposition efforts for all member states plus the EEA countries Norway, Iceland and Liechtenstein, which are also required to comply with the new regulation.

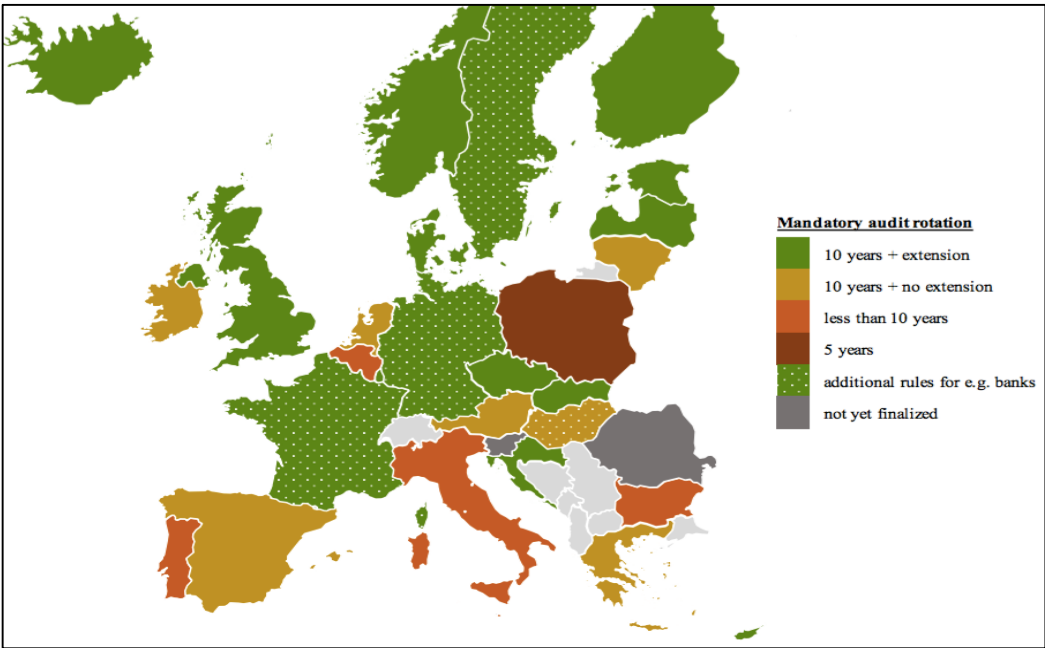


Figure 2: Mandatory rotation in Europe after EU audit reform

From the figure it is apparent that most member states have followed the EU baseline and implemented a maximum duration period of 10 years. Just a few countries (Belgium, Italy, Bulgaria, Poland, Portugal) passed more stringent regulations. The most radical exception is Poland, where the government plans to not only shorten the rotation period, which shall be set to five years, but also plans to implement an even stricter limit than the proposed 70% for fees gained through providing non-audit services. Bulgaria also reduced the maximum period to just seven years and introduced mandatory joint audits for banks and insurances, thus it might be argued that auditor independence is a bigger concern in the Eastern-European countries. In case of Italy it has to be recalled that mandatory rotation already existed earlier and the maximum period was shorter before the reform (nine years) and has not been changed due to the reform. It should be mentioned that once appointed in Italy, the auditor is retained for the whole period with few options to terminate or decline the engagement at any earlier date.

Belgium also reduced the maximum period to nine years, but it implemented the options to extend the period through a tender process for another 9 years and joint audits can extend the period for another 15 years. It is noteworthy that the three biggest economies in Europe (Germany, France, Great Britain) have all chosen to implement the option to extend the maximum period, thus only Great Britain abstained from tighten the regulation at all. At least they plan to keep mandatory rotation after their exit from the EU. France reduced the extension period to six more years, in case no joint audit is performed.

At a glance it is apparent that the German and Swedish approach is in line with the strongest economies in Europe and the other Nordic countries (Norway, Denmark, Finland), which all opted to implement the optional extension of the rotation period and all implemented the maximum amount of years.

2.3 Audit firm rotation

As highlighted by the European Commission a compulsory rotation requirement is the central element of the EU audit package in order to promote audit quality, enhance auditor independence and increase competition in the market. Mandatory rotation requires firms to change their auditors after a predefined duration period. The debate about mandatory rotation can be traced back several decades and has often been influenced through corporate scandals, because it is often seen as a potential instrument to enhance audit quality by improving the auditors' independence (Imhoff, 2003). This and other arguments pro and contra mandatory rotation have been profoundly discussed within accounting research. However, there has been no general agreement on the actual impact of a rotation regime (Fontaine et al., 2015).

In addition, firms generally do not change their auditors often, e.g. on average only up to 3% of publicly held firms in the U.S. change their auditor on an annual basis (U.S. GAO, 2003). This results in few empirical studies about the implications of mandatory rotation and most research relies on experimental and theoretical studies (Elder, Lowensohn & Reck, 2015). Furthermore, most research about mandatory rotation substitutes audit tenure for rotation due to the low amount of empirical data from rotation regimes. There is also a lack of literature that examines the implications of mandatory rotation on auditor independence from a legitimacy perspective, as it is rather difficult to measure auditor independence. Nevertheless, there is a large base of research dealing with the discussion about the implementation of a mandatory audit partner/firm rotation, which is presented in the following parts.

2.3.1 Proponents of mandatory rotation

Proponents of mandatory rotation often contend that the possibility of an unlimited period of association between auditors and their clients will negatively affect the independence of the auditor (Kaplan & Mauldin, 2008; Imhoff, 2003; Gietzmann & Sen, 2002). The proponents argue that limiting the audit tenure will enhance audit quality by reducing the client's influence on the auditor as well as reducing auditor complacency (Kaplan & Mauldin, 2008). This is in line with the European Commission, which argues that mandatory rotation will enhance auditor independence and increase competition (EC, 2011a).

It was also one of the supportive arguments used by the PCAOB in its attempt to revive the political debate about mandatory rotation in the U.S. again (PCAOB, 2011a).

Most research supporting rotation regimes is based on experimental and theoretical settings due to a lack of empirical data. Gietzmann & Sen (2002) e.g. construct a game-theoretical model, where the auditor is modelled as an economic agent, whose desire to maintain independence is driven solely by economic forces like present and future fee income. The authors argue that the rotation regime can increase incentives for auditors to not collude with management under certain circumstances (Gietzmann & Sen, 2002). Although they are often cited as proponents of mandatory rotation, their research actually supports rotation regimes only in very specific cases, while otherwise the costs would outweigh the benefits.

Experimental studies conducted by Dopuch et al. (2001) and Wang & Tuttle (2009) markedly support the implementation of mandatory rotation. Multi-period interactions between managers and auditors led to auditors compromising their independence and adjusting assessments in favour of their client the most often in absence of a rotation or retention requirement, while implementing such a requirement minimized complaisant decisions (Dopuch et al., 2001). Simulations of audit-client negotiations in an experimental setting also support these findings and describe auditors as less cooperative in mandatory rotation scenarios, while otherwise adapting more to the client's perceptions (Wang & Tuttle, 2009). Nevertheless, these studies must be considered with caution, since both studies rely on experimental and laboratory settings and several limitations constrain the usefulness of their findings. For instance, the authors partly use business students as a mean to explore the topic and ignore switching costs in their settings. The findings from these studies as well as from related experimental research about mandatory rotation therefore have to be treated carefully, when generalized.

However, recent research from Italy also suggests a positive impact from implementing a rotation requirement (Cameran et al., 2016). Assuming audit quality is linked to accounting conservatism the authors conclude that mandatory rotation leads to a higher level of accounting conservatism and thereby also to a higher level of audit quality in the last engagement period before the audit firm has to be changed and thus emphasize the positive effects from rotation.

2.3.2 Opponents of mandatory rotation

On contrary, opposition towards mandatory rotation is manifold and widespread. Although the concept is decades old, it has not been implemented by most countries. Most recently the U.S. Congress turned down nascent efforts to consider the possibility of a rotation requirement by passing a bill that explicitly prohibits mandatory rotation (U.S., 2013). Most professional bodies linked to the audit profession consulted during the public consultations about new audit regulations in both the U.S. and the EU strictly opposed mandatory rotation (EC, 2011b; PCAOB, 2011b). Within its concept the PCAOB also addresses one of the main arguments against mandatory rotation by highlighting concerns about the costs.

“Rotation would considerably increase the costs of audits because of the frequent duplication of the start-up and learning time necessary to gain familiarity with a company and its operations that is necessary for an effective audit.” (PCAOB, 2011a, p.11)

Most research opposing the implementation of a rotation regime derives from investigating the effect of audit tenure on audit quality, mainly due to the lack in data about rotation (Lennox, Xu & Whang, 2014; Cameran, Francis, Marra & Pettinicchio, 2015). Some of these studies (e.g. Mansi, Maxwell & Miller, 2004; Gosh & Moon, 2005) explore the effect of audit tenure on perceived financial reporting quality by using cost of debt and earnings response coefficients, while other studies (e.g. Johnson et al., 2002; Stanley & DeZoort, 2007) focus on actual financial reporting quality (Lennox et al., 2014). Gosh & Moon (2004) conclude that investors tend to perceive that earnings quality is augmenting with longer audit tenure. They also identify financial analysts as more likely to perceive financial information from a firm with longer audit-client relationships as more reliable. In line with their findings Mansi et al. (2004) explore that the required return on corporate bonds declines with longer audit tenure and conclude that mandatory rotation could diminish the perceived audit quality in the long-run. Furthermore, Johnson et al. (2002) investigate the actual financial reporting quality by using accrual proxies. They explore if the audit tenure affects the quality of those accruals and subsequently audit quality. According to their findings shorter audit tenures (two to three years) are more likely to generate financial reports of lower quality, compared to longer tenures. In addition, the authors do not find evidence for a decline in audit quality with longer audit tenures. In line with these findings Stanley & DeZoort (2007) explore the relation between audit tenure and financial restatements and conclude that shorter audit tenures result in an increased likelihood of a restatement. Those both studies together with additional research (George, 2004; Carcello & Nagy, 2004) illustrate that audit quality is likely to be lower in the first years of an auditor-client relationship, which might be explained by a lack of client-specific knowledge. It is accompanied by research that investigates the relation between audit failures and audit tenure, which points out that auditors might be more concerned about fee recovery and therefore more easily persuaded in the first engagement years (Geiger & Raghunandan, 2002). In an overall assessment of these studies related to the relationship between audit tenure and financial reporting quality, most cannot find evidence for a decline in quality with longer tenures, but are firmly indicating that audit quality in the first years is significantly lower (Lennox et al., 2014).

Actual empirical data is scarce, however, Ruiz-Barbadillo et al. (2009) explore the effect of mandatory rotation on auditors' proclivity to issue going-concern audit opinions in Spain. From their perspective, the abolition of the mandatory rotation regime did not alter audit quality and they argue that incentives steaming from free market conditions (e.g. firm reputation) might be a more effective enforcer of auditor independence (Ruiz-Barbadillo et al., 2009).

Another strong argument used by the opponents of mandatory rotation has been the costs that would be imposed on businesses. Gerakos & Syverson (2015) estimate the financial consequences of an implementation of mandatory rotation for firms in the U.S. to be enormously. A surplus loss of 2.7 –

5.0 billion US Dollar for publicly traded firms in the U.S. could be faced through such a requirement. It would even accumulate to higher sums, if the rotation periods would set rather short. These losses represent losses to the firm's shareholders since they can be conceptualized as agency costs. Relying on these numbers, Gerakos & Sverson (2015) firmly argue against the implementation of a rotation regime. Overall, there is a tendency in research to reject the concept of imposing a requirement to change the audit firm (Cameran et al., 2015). This has also been acknowledged by the PCAOB in their 2011 proposal, however, the PCAOB also highlights the difficulty to draw conclusions from research, since most studies substitute audit tenure for rotation. This might deter results, because audit firms are in general changed for a variety of reasons, including the calculation of fees, opinion shopping, financial distress or a decline in performance (PCAOB, 2011a).

2.3.3 International experience

Despite being discussed over decades, mandatory rotation has only been implemented in very few countries so far. It has come into law in countries like Canada, Italy, Singapore, Spain, South Korea and Brazil, even though the requirement has often been abandoned or was just applied to certain branches.

Brazil as South America's strongest economy established a rotation policy from 1999 on, requiring all listed firms to rotate their auditors every five years. It has been eased afterwards in 2007 and the period has been extended (Antonio & Bassetti, 2014). While Singapore established mandatory rotation policies in 2002, forcing domestic banks to rotate their auditors every five years, the Canadian authorities lifted similar rotation regulations imposed on domestic banks after decades due to a lack of proven benefits. Austria planned to implement a six-year regulation in 2004, however this regulation was rescinded before it came into force, because the costs were considered as outweighing the benefits of rotation.

Mandatory rotation in Spain was established in 1988 when a maximum duration period of nine years and a minimum initial period of three years were implemented. However, the requirement was already abolished in 1995 and auditees were able to renew contracts on a yearly basis meaning that the rotation requirement has never been completely enforced. Regulators referred to the law as insufficient and not able to achieve the promised benefits: "*did not achieve its objectives of public policy*" (Carrera et al., 2007, p. 674). The only research from a Spanish setting stems from Ruiz-Barbadillo et al. (2009), who compare the periods from 1991-1994 with 1995-2000. Although the authors position themselves as opponents of rotation, their research does not actually refer to a consequent mandatory rotation regime and it remains unclear, if the rotation in Spain had an effect on audit quality (Lennox et al., 2014).

In the aftermath of worldwide corporate scandals South Korea adopted a mandatory rotation policy in 2003 requiring firms to rotate their audit firm after six years. Thus, also in this country the law was never completely enforced as it was abandoned in 2010 before the end of the first rotation period. Nonetheless, research from Kwon et al. (2014) tends to support opponents of the rotation policy, as the authors were not able to find evidence for an increased audit quality, but point out an increase of costs

for both audit firms and clients. Due to the specific characteristics of the Korean market, the results of this study however might not be transferable to western countries. (Kwon et al., 2014)

Italy with the most well documented rotation regime issued its first rotation policy far back in 1975, expanded its scope in the mid 80's and again in the late 90's. In the beginning audit contracts were allowed to be renewed twice for another three years, adding up to a maximum tenure of nine years and guaranteeing a minimum of three years' initial engagement. It has been recently altered and the renewal option has been abandoned. Once appointed, the auditor is now retained for the full period of nine years (Cameran et al., 2016). Noteworthy, the audit market is rather thin in Italy and the Big Four overwhelmingly dominate the market with more than 90% market share, which might be more suitable for a rotation requirement (Cameran et al., 2015).

Studies conducted within the Italian environment reveal mixed results. Previous research by Cameran et al. (2015) did not find supportive arguments for the rotation regime in their studies concerned with earnings quality. Furthermore, partner suspensions for poor quality in first year audits were rising and the dominance of the Big Four even increasing (Cameran et al., 2015). However, as pointed out in the chapter before, most recent research from Cameran et al. (2016) highlights a distinctively higher audit quality in the last period before the auditor has to be rotated.

2.4 Auditor independence

According to the EU, one main objective of mandatory rotation is to ensure a sufficient level of auditor independence and thereby enhance audit quality. Auditor independence has been recognized as *“the cornerstone of the accounting profession and one of its precious assets”* (Mednick, 1997, p.10) by accounting literature and various professional bodies. It has evolved to the focal point of the debate about more extensive audit regulation in recent years (Geiger & Raghunandan, 2002; Bamber & Iyer, 2007).

Concerns about the independence of auditors and consequently about their ability to assess facts without being influenced by their relationship to the client undoubtedly lead automatically to a decrease of trust in their service (Chandler & Edwards, 1996). Eroding this trust will then reduce the legitimacy of the audit itself, as it does not fulfil the public expectations anymore. Therefore, independence has been described as a key aspect of audit quality and essential in order to display commitment to *“the values, ethics and attitudes necessary to support a quality audit”* (IAASB, 2014, p.8). There has been a variety of definitions for the concept of independence, as been summarized by Beattie & Fearnley (2002):

- *“the ability to resist client pressure”* (Knapp, 1985, p.203)
- *“freedom from those pressures and other factors that compromise, (...) , an auditor's ability to make unbiased audit decisions”* (ISB, 2000, p.3)

Nonetheless, according to DeAngelo, auditor independence can be described as the ability of an auditor to report the previously revealed breach in the client's financial statements (DeAngelo, 1981). Within

this context, the concept of independence has then often been divided into two different dimensions: “*independence in mind*” and “*independence in appearance*” (IESBA, 2016, p.46).

On the one hand, independence in mind is regarded as the true independence. It refers to the auditor’s ability to conduct the audit and any professional judgment impartially and without being compromised by other parties. According to the IESBA’s Code of Ethics it is the capability of an auditor to act with integrity and ensure objectivity and professional scepticism (IESBA, 2016).

Independence in appearance on the other hand refers to the auditor being seen as independent by investors and the public. It indicates, whether the audit team appears to be independent and unattached by factors that compromise the auditor's integrity (Dopuch, King & Schwartz, 2003). It can be depicted as the perceived independence of the auditor (IESBA, 2016).

Both dimensions are intertwined with each other: if stakeholders do not trust the independence of auditors, even when they are in fact independent, the validity of their results will be questioned. A perceived lack of independence might therefore have the same severe consequences like an actual violation of independence (Olazabal & Almer, 2001). It can threaten the legitimacy of the audit profession itself. Thus, it is necessary for auditors to maintain independent in mind but also circumnavigate potentially compromising situations that could raise questions about their independence. A high level of independence in appearance is crucial for being seen as legitimate by the public.

Threats towards independence are multifaceted and identifying and mitigating those threats is a major task for the statutory auditor and their team. The IEASB defines a series of threats that auditors are regularly exposed to in its Code of Ethics framework. It includes threats related to self-interest, self-review, advocacy, familiarity or intimidation issues. It gives guidance to auditors and provides safeguards against possible threats. Those safeguards can either be created through regulations or the profession itself (IESBA, 2016). However, if the threats cannot be lowered to an acceptable level or appropriate safeguards are not available, the auditor is obliged to terminate the engagement.

The threat of familiarity relates to the possibility of an overly close relationship between auditor and client. The familiarity threat can e.g. stem from previous personal relations or it can also slowly arise over time due to a long and close relationship between the audit firm and client. It might then end up in the auditor being influenced by the client’s perceptions of certain actions, being personally attached to the firm and its employees or just being too careless when questioning certain issues. The debate about mandatory audit firm/partner rotation has therefore often focused on audit firms or partners long and close relationships to certain audit clients and discussed if this might create potential familiarity threats (Kaplan & Mauldin, 2008). According to the European Commission, concerns about the independence of auditors and potential familiarity threats have accumulated with the global financial crisis and the following years (EU, 2014). It can be argued that it has resulted in a legitimacy gap between society’s expectation towards auditor’s independence and how auditors pursue their activities (FT View, 2017). This amongst others has encouraged European legislators to push forward a mandatory rotation.

3. Research Design

This chapter delineates the research design of the study. It outlines the structure of the study as well as the data collection and the research process. It finishes with the limitations of the study.

3.1 Research method

Good research, regardless of the chosen method, aims to better understand reality (Power & Gendron, 2015, p. 153). There is no exact definition of how to conduct research, rather there is a range of different approaches from which researchers can choose from. However, research methodologies can be differentiated in quantitative or qualitative methodologies. In general, methodologies can be depicted as an overall research strategy towards the study phenomenon (Silverman, 2013). A qualitative methodology then focuses on exploring a social order created through interactions between different actors and is based on subjectivity (Silverman, 2013). On contrary to methodologies, research methods can be described as certain research techniques (Collis & Hussey, 2014).

Qualitative research enables the researcher to explore an object of study not only from various perspectives, but also avoids the limitation of mere testing of previously defined theories. According to Cooper & Morgan (2008) qualitative research is especially suitable for studying the complexities of expert practices like auditing (Power & Gendron, 2015). It displays the research object as a whole and provides multiple perspectives by integrating the different viewpoints from a variety of actors (Silverman, 2013). Due to the nature of the purpose of this study and also considering that quantitative data will not be available in the next few years a qualitative approach has been chosen for this study.

The debate about mandatory rotation and its implications on the audit market has been discussed from several perspectives in recent years. This study enhances the existing body of research by identifying how legitimacy is created in the discourse and aims to provide a greater understanding of the implications of the rotation requirement in Germany and Sweden. It draws on legitimacy theory and in particular Whittle et al.'s (2014) framework of discursive strategies in order to reveal the discursive strategies used by different stakeholders and to structure the arguments made in the debate.

I chose Germany and Sweden as the countries of interest for this study, because both countries have a similar accounting tradition as well as a similar legal environment, which from my point of view allows to generalize findings from one country to the other. Focusing on the Swedish audit environment enables me then to obtain the latest viewpoints from practitioners, while including a German perspective widens the base of available documents, as the Swedish market alone is relatively small in an overall view.

Moreover, this study follows an interpretivist paradigm. Interpretivism rests on the assumption that social reality is subjective and affected by the research process (Collis & Hussey, 2014). On contrary to positivism, where only observable and measurable phenomena can be validly regarded as knowledge, interpretivism acknowledges that knowledge can arise from subjective evidence. It is linked to observing and analysing different perceptions of a phenomena. Interpretivism then allows to generalize findings

from this particular setting to other similar settings. (Collis & Hussey, 2014). This study therefore applies an exploratory phenomenon study approach where more emphasis is placed on a contextual analysis of certain events and interrelations (Blumberg et al., 2011). Exploratory studies build on new ways to address a topic in order to achieve a greater understanding and suggestions for further research.

Analysing the different viewpoints by using legitimacy theory and a framework to highlight the discursive strategies used within the debate can add a legitimacy perspective to the ongoing discussion and reveal how the regulation is used to create legitimacy. It is also an approach that has not been used before and thereby contributes to the academic debate about mandatory rotation and also aims to establish a better understanding of the regulation with a focus on a German and Swedish setting.

This thesis is structured in three parts in order to present and analyse the primary data generated within the study and connect it to previous literature and the theory used in this study. Firstly, the previous literature on rotation, auditor independence and the theoretical framework are presented in the frame of reference. In the next step the findings from both, the document analysis and the interviews, are presented in chapter four and related to the framework established by Whittle et al. (2014). In the third step the findings are related to previous literature on mandatory rotation and legitimacy in chapter five.

3.2 Research approach

The frame of reference provides an overview about the context of the regulation and the discussion about mandatory rotation in the last decades. The literature used within this study was acquired through the databases at the School of Business, Economics and Law at the University of Gothenburg. Furthermore, information about the new EU regulation was collected from the web presence of the EU and supplemented by information from the webpage of both national governments. Those findings were enriched with information from the webpages of audit firms that provided general overviews.

The study is then based on a document analysis of a variety of comment letters sent to the European Commission and statements released by the commission itself, supplemented by a series of interviews with Swedish practitioners. Document analysis is often used in qualitative research, as it produces profound descriptions of a research topic and helps to develop a meaning and understanding of the topic investigated (Bowen, 2009). It can provide a broad coverage of data and background information (Bowen, 2009). In this study, a document analysis is suitable as it reveals the different attitudes towards mandatory rotation from a variety of stakeholders and provides a broad foundation for the analysis of how the different actors attempt to create legitimacy for the existing practices or the new regulation. The additional data generated from the interviews then contributes to the study by providing an overview about the perceptions of market participants in Sweden regarding the implications of the new regulation on rotation and how it influences the audit environment in Sweden.

The document analysis relies on the general analytical procedure for analysing qualitative data from documents as described by Miles, Huberman & Saldaña (2014) and combines their approach of

systematic processing the data with a textual analysis of the debate around mandatory rotation. Following Miles et al.'s (2014) procedure I collected and reduced the data from the documents in the first step. After collecting the data from all documents as outlined in the next paragraph, I filtered the data by skimming through all documents with a focus on the topic of mandatory rotation as well as a focus on text that can be related to how legitimacy is created. By this, I was able to substantially reduce the amount of text towards an amount that I was able to examine with greater detail.

This base of data was then supplemented with the information generated from the interviews. Interviews are another research method to gather data by asking selected participants about their perceptions and beliefs towards a certain topic. When following an interpretivist approach, interviews “are concerned with exploring data on understandings, opinions, what people remember doing, attitudes, feelings and the like, that people have in common” (Collis & Hussey, 2014, p.133). I conducted four interviews with practitioners in Sweden in order to verify the findings from the document analysis. The interview notes and transcriptions were then added to the other data from the document analysis and evaluated in detail.

As this study is inspired by Whittle et al.'s (2014) framework on discursive strategies, I rely on a textual analysis to discover and reveal the strategies used by the European Commission and various stakeholders in order to create legitimacy for their practices and positions.

3.2.1 Data collection

The document analysis comprises 16 statements released by the European Commission during the drafting and finalizing process of the EU audit package as well as 39 comment letters written by a multitude of stakeholders from Germany and Sweden in response to the call of the European Commission to contribute to the debate about mandatory rotation and the EU audit reform in general.

The documents released by the EU were selected after a comprehensive search on all websites associated with the European Commission and comprise all officially released statements from the European Commission and associated bodies with regard to the EU audit package during the timeframe from 2010 – 2016. The comment letters were selected out of a total of nearly 700 comment letters that were sent to the European Commission during the drafting process. Firstly, the responses of the seven biggest audit firms were chosen due to their influence on the topic. In a second step, responses from Germany and Sweden were selected in order to achieve detailed insights regarding these both countries. The selection comprises all responses with a Swedish background (in total 11) and a representative selection of responses with a German background (in total 16) in addition to responses with a multinational background (in total 12). Most comment letters were submitted from Germany, thus it was necessary to further narrow the selection of responses from Germany and I excluded all responses submitted by individuals or small sized entities/associations, as well as I chose only a set of representative responses from academics to be included in the sample. From my understanding, the selected responses provide a representative collection of the arguments made by German respondents. The responses with

multinational background consist of the largest seven audit firms in Europe, one consultancy firm, one NGO and several international standard setters that were selected due to their influence on the debate and in order to provide a comprehensive selection of the different respondent groups. Appendix 1 and 2 provide an overview about the documents used within this study.

In order to gather additional data, four interviews with practitioners in Sweden were conducted. The interviewee selection was based on an understanding that the interview partners must have a profound knowledge of the EU reform and might be affected by the regulation, so that the credibility of the data generated through the interviews is guaranteed. This minimized the potential respondent base to senior auditors which work on a managing level and e-mails were sent to all audit partners and directors at the six biggest audit firms in Gothenburg, where contact details were available. However, throughout the study it turned out that motivating respondents to participate in an interview can be rather difficult. The language barrier as well as the timing during the busy season of auditors might have reduced the willingness of additional respondents to participate. However, I am confident that the conducted interviews provide a sufficient picture of the viewpoints of practitioners in Sweden.

Audit Director (A1)	Big Four firm	Audit Partner (A3)	Non Big Four firm
Audit Director (A2)	Big Four firm	Accounting Expert (BR)	Business association

Table 3: List of interview partners

I considered a semi-structured interview setting as appropriate for this study. A semi-structured interview setting allows the researcher to encourage the respondents to elaborate on the main topics of interest and to develop further questions during the course of the interview (Collis & Hussey, 2014). It still provides a certain direction and set of questions by using a pre-defined interview guide, but offers the respondents the freedom to focus on their perspective. The interview questions were based on the new EU regulation and previous literature on mandatory rotation and were focused on the individual perceptions of the topic. During some interviews not all questions were asked in case the respondent already provided the relevant information on its own in another answer. Three interviews were conducted in person and one via phone. They lasted in general approximately 45 minutes. Notes were taken during the interviews and the interviews were recorded when permission was given by the respondents, which makes sure that no information is missed out in the course of the analysis. In order to overcome potential discomfort with the interview, all respondents were assured of their anonymity in the study. The interview guide can be found in appendix 3.

3.3 Research quality

In order to ensure the trustworthiness of the study and enhance the research quality the following four characteristics have been taken into account while pursuing this study. The objective of trustworthiness is to ensure an ethical research approach as well as a correct interpretation and presentation of the data.

Firstly, credibility refers to the correct identification and description of the subject of study and can be improved by using different sources as combining document analysis and interviews to acquire the data (Collis & Hussey, 2014). However, observer bias or observer caused effects and complexities in the data acquiring process are typical threats in qualitative research that the author has to be aware of. Transferability then refers to the ability to convey the findings to another setting in order to allow generalization. By providing a profound description of the findings the study aims to enable the reader to transfer findings to e.g. another regulation drafting process. Dependability is concerned on whether the research process is logically structured and documented (Collis & Hussey, 2014). This study aims to follow a consistent structure and provides an overview about the research approach in this chapter in order to ensure a sufficient amount of dependability. Lastly, confirmability refers to the ability to assess whether the findings arise from the data. By using a multitude of citations in order to display the different viewpoints, I aim to enable the reader of this study to comprehend the flow from data to findings.

3.4 Limitations

It is important to outline the delimitations and limitations of this study. The selection of documents can be regarded as a delimitation, because not all of the submitted comment letters were examined and there might be a bias towards large institutions and shareholder representatives. However, I consider the chosen documents as a representative selection of the German and Swedish sources with a focus on the most influencing actors that participate in the consultation process. The amount of interviews leads to another delimitation of the study. Even though from my understanding more interviews would not have led to additional or new arguments, they might have strengthened the findings from the previous ones.

Limitations describe weaknesses or deficiencies in the research process (Collis & Hussey, 2014). Using a qualitative methodology to examine the process by which legitimacy is created for and against mandatory rotation can be perceived as a limitation of this study, as it is often argued that qualitative research is too dependent on subjective perceptions. The findings of this study rely inevitable on some subjectivity as they are based on the author's interpretation of the documents analysed in the study and the interviewees answers. However, Power & Gendron (2015) argue that auditing can be studied productively in several ways and this study seems suitable for a qualitative methodology as it captures different perceptions. The complexity and instability of reality is too powerful and dynamic to limit the selection of research methodologies and methods (Power & Gendron, 2015).

The chosen research approach might limit the study, as it can be argued that there is more than what we are talking and writing about and written and spoken language is always to some extent the product of socially influenced interests (Collis & Hussey, 2014). By recognizing that documents are written with a distinct purpose and using mixed methods, this study aims to overcome this limitation. Still, there also might be a risk due to the language and the recording of the interviews as both could have limited the respondent's choice of answers.

4. Empirical Findings and Analysis

This chapter outlines the arguments pro and contra mandatory rotation used in the documents and the interviews. They are then related to the discursive strategies identified in the theoretical framework.

The empirical findings in this study consist of the document analysis and the interviews conducted. Firstly, the arguments made in the comment letters stemming from German and Swedish sources will be examined and compared with the arguments made by the European Commission. The interviews are then used to verify the arguments made in the debate and to establish another perspective towards the discourse. Appendix 5 summarizes the main arguments used in the discourse on mandatory rotation and includes two tables with an overview about the frequency of the arguments in the comment letters.

4.1 EU statements

In total, 16 statements released during the legislation process by the European Commission and associated bodies are evaluated within this section. They provide an overview about the arguments made to establish legitimacy for the new mandatory rotation requirement and reveal the rationale behind the reform. A list of the selected EU documents can be found in Appendix 1.

The intention behind mandatory rotation is clearly visible throughout the statements. The reform has its roots in the aftermath of the global financial crisis and the pressure on politicians and legislators to act in response to the crisis is definitely apparent in the statements. The European commission detected two major weaknesses of the audit market that set the direction for the reform. From their point of view, the crisis uncovered a lack of auditor independence, which subsequently led to a decline in audit quality. Furthermore, the market dominance of a few very large audit firms leads to an unprecedented and undesired concentration at the top end of the audit market. The EU commissioner justifies the reform:

“Today’s proposals address the current weaknesses in the EU audit market, by eliminating conflicts of interest, ensuring independence and robust supervision and by facilitating more diversity in what is an overly concentrated market, especially at the top-end.” (Press release, 2011)

The new regulation is thus designed to achieve three main objectives:

- ensure and enhance audit quality
- reinforce and improve the independence and professional scepticism of auditors
- spur competition and make the top end of the audit market more dynamic

On the one hand, the commission has to implement regulations that effectively address the weaknesses in order to achieve their objectives. On the other hand, they have to create legitimacy for the new regulations in order to motivate others to accept the process of change (Black, 2009). As being considered as legitimate is of great importance to the audit profession, the debate about rotation can also be seen as a debate about legitimacy. By relating the arguments made by the European Commission in the discourse to Whittle et al.’s (2014) framework, some of the strategies used to de-legitimize the old practices can be identified.

Stake attribution is a strategy to de-legitimize a certain practice and refers to the process of ascribing illegitimate or questionable interests and motives to another party (Whittle et al., 2014). The commission argues frequently that there is few doubt about the familiarity threats stemming from long auditor-client relationships and their negative impact on the auditor's ability to work independently as well as their professional scepticism.

“There are obvious risks to having the same auditor for 50 or 100 years as it happens today. Such a long professional relationship undermines the auditor's independence and negatively impacts on his/her professional scepticism.” (Memo, 2011)

“In a long term audit relationship, the auditor will tend to identify too closely with the management.” (Working paper, 2011)

“In order to address the familiarity threat (...) it is important to establish a maximum duration of the audit engagement.” (Regulation, 2014)

From their point of view, such long-term relationships result in an overly close identification of auditors with the client, inducing them to be more reluctant to critically assess the financial statements of the audited entity. In order to add credibility to their argumentation, the commission refers to research from Dopuch et al. (2001), which concludes that long-term relationships lead to more assessments in favour of the client. A second argument used to argue for a limitation of the audit tenure is based on the belief that these long-term relationships lead to simple repetition of the audit procedures year for year, which in turn results in an anticipation of potential deficiencies rather than being alert to subtle circumstances.

“Auditors may become stale and view the audit as simple repetition of earlier engagements.” (Working paper, 2011)

Through highlighting those arguments, the commission distinctively tries to establish the image of the audit profession as more concerned with raising profits and maintaining revenue from existing clients, rather than being focused on a proper execution of their duties. By ascribing this behaviour as the true motive to the audit profession the commission uses stake attribution as a mean to de-legitimize the current practices and to cast a very poor light on the audit profession's ability to handle the issues. This is in line with their understanding that the current practice of partner rotation is not sufficient. From the commission's point of view, the *“main focus remains client retention”* (Memo, 2011), even though the key audit partner is rotated. They argue that the incoming partner is under pressure to not lose the client and is also not willing to question the practices of their predecessor openly. These arguments can be seen as anticipating and responding to the stake inoculation and stake alignment strategies used by the audit profession in the discourse, which often refer to internal audit partner rotation as an already existing and sufficient safeguard against the threat of familiarity and pure repetition.

Stake interrogation is another discursive strategy to de-legitimize a certain practice or action identified by Whittle et al. (2014) and can also be observed within the EU statements. Stake interrogation refers to the discursive process of questioning the legitimacy of the interests, stake and motive of another party

(Whittle et al., 2014). It can be used to highlight the scepticism towards statements that downplay alleged misbehaviour, by relating the actions of the other party to some kind of hidden motive or interest. Within the EU's statements, the banking sector is repeatedly singled out as the biggest failure of auditors, because some banks received unqualified audit statements just weeks before they ran in trouble and some of them were due to be bailed out. For instance, it is stated in one of the press releases:

“The 2008 financial crisis highlighted considerable shortcomings in the European audit system. Audits of some large financial institutions just before, during and since the crisis resulted in ‘clean’ audit reports despite the serious intrinsic weaknesses in the financial health of the institutions concerned.” (Press release, 2011)

Through those constant references to the banking sector, legitimacy for current audit practices is reduced and legitimacy for new regulations, which are supposed to overcome those failures, is created. In this context, stake interrogation is linked to the continuous emphasis on the confusion about ‘clean’ audit reports for banks in distress. It seems obvious and plausible to everyone, but especially to the public that auditors should not have provided unqualified reports during the crisis. Constant questioning the motive or interest why auditors still issued those ‘clean’ reports then results in questioning the legitimacy of the audit practices and linking their behaviour to a hidden motive.

However, most prominent in the legitimation strategy of the European Commission is the argument that auditors have misinterpreted their role within society. The need for auditing is based on the understanding that auditors can solve the agency problem. The auditors' work shall ensure the public of the credibility of the firm's financial statements, instead of predominantly serving the clients.

“Audit firms play an important societal role by providing investors and shareholders with an opinion on the accuracy of company accounts.” (Statement, 2014)

“This entrustment responds to the fulfilment of a societal role in offering an opinion on the truth and fairness of the financial statements of audited entities. (...) It's time to probe into the true fulfilment of this societal mandate.” (Green Paper, 2010)

Through emphasizing the claim that auditors steered away from their societal role, the commission uses the third type of discursive strategies identified by Whittle et al. (2014). Stake misalignment refers to the process of claiming the interests or motives of the other party are misaligned with those considered to be legitimate (Whittle et al., 2014). The European Commission insists that the role of an auditor is mainly driven by society's desire to ensure corporate compliance with existing laws. They then accuse the audit profession of having other misleading perceptions about their role.

“It is now high time for auditors to meet the challenges of their role – a societal role.” (Memo, 2013)

Long-term relationships and lacking competition would have steered away auditors from fulfilling their intended role. By pointing out this inconsistency between public and professional perceptions of the auditor's role, they de-legitimize not only the current audit practices but the audit profession itself.

Again, mandatory rotation is then delineated as a measure to overcome the legitimacy issue and to help the audit profession to be perceived more legitimate by the public again.

The use of stake misalignment is also perceivable from Commissioner Hill’s speech in front of European investors in May 2015. He refers to the trust that society has put in auditors, which in turn lacked sufficient independence and scepticism to return the trust and he emphasizes the following damage.

“Who loses out in such situations? Investors, shareholders. Your pension scheme, investment fund or insurance policy.” (Speech, 2015)

He claims that the current practice of long auditor-client relationships only benefits the auditors but not society as a whole. This can be seen as claiming that auditors’ interests are not aligned with the interests of the broader society. By using stake misalignment, the commission frequently aims to justify their actions and to legitimize mandatory rotation as a mean to remind auditors of their broader societal role.

In general, most arguments of the EU claim that mandatory rotation will increase auditor independence by limiting the intensity of the auditor-client relationship. The fresh view brought in by the new auditor will lead to an in-depth analysis of the firm’s statements which will subsequently increase audit quality.

“Mandatory audit firm rotation will help reduce excessive familiarity between the statutory auditor and its clients, limit the risks of carrying over repeated inaccuracies, and encourage fresh thinking, (...) Mandatory rotation will hence contribute to a better audit quality.” (Memo, 2014)

Limiting the audit tenure will also address the strong dominance of the Big Four firms by stimulating regular competition and open up the market for other competitors. Mandatory rotation will thus especially increase the independence in appearance and thereby raise legitimacy for the audit system itself. Furthermore, the European Commission asserts that mandatory rotation will in the long run lower the costs for the audited entities as the quality increases and fewer audit failures occur.

4.2 Comment letters

In total, 39 responses to the new regulation are evaluated within this section. They delineate the arguments made by the audit profession and other groups affected by the new regulation. Appendix 2 provides an overview about the selected comment letters and their stance towards mandatory rotation.

The comment letters can be distinguished in responses from the audit profession, professional bodies, academics, preparers, users, public authorities and others. Noteworthy, only a minority of the respondents support mandatory rotation in any way. It is rejected by nearly all members of the audit profession and gains only some support from academics and individual respondents.

Mandatory rotation	
Supportive:	5
Opposition:	25
Slight support:	4
No opinion:	5

Appendix 5 provides an overview about the frequency of the particular arguments used in the comment letters, which gives an impression of the main pro and contra arguments applied by the respondents.

4.2.1 The ‘Big Four’

All of the large audit firms strongly reject the implementation of a rotation regime. However, they differ in their argumentation why they oppose mandatory rotation in some ways. This might be explained by the fact that within their comment letters they have to balance the issue of being perceived as legitimate by the public and at the same time maintaining their interests and operational efficiency.

Deloitte, KPMG and EY for instance pursue a stake inoculation strategy in order to restore legitimacy by drawing on the cost argument to underline their opposition. Stake inoculation refers to the process of denying or down-playing that someone has an illegitimate interest in a particular course of action (Whittle et al., 2014). According to Deloitte, mandatory rotation would certainly increase the costs for the audited entity due to internal costs from explaining the business to the new auditor. KPMG highlights the time spent by management and senior personnel in the replacement process. By emphasizing the cost burden imposed on the audited entities, they use stake inoculation and deny having any illegitimate interests. Instead they relate their opposition to an increase in costs, which would not be in the public interest. The audited entities would be worse off and this would harm not the auditors but everyone else.

“Given the increased cost to business and risks to audit quality (...) we do not believe that limiting the right of shareholders to appoint the auditor of their choice can be justified.” (Deloitte)

They base their argumentation on research from Italy, where mandatory rotation led to an increase in costs.¹ However, EY also implicitly refers to a cost increase for the audit firms:

“While audit firms obviously can and do manage transitions effectively, this is not without cost.” (EY)

It thereby undermines the stake inoculation strategy to some extent as it reveals the ‘real’ fear of competing on a regular basis with the downward fee pressure to win the client.

Stake inoculation is furthermore used by all four firms, when they firmly deny potential market dominance and a lack of competition. PWC and EY counter the claim of too less competition in the audit market by explicitly denying any lack of competition and emphasizing the price competition.

“we believe that competition on price is particularly intense” (PWC)

“the level of competition among accounting firms is intense, with firms competing fiercely based on accounting expertise, audit quality, industry knowledge, firm culture, price and productivity” (EY)

In this context, stake inoculation is used to deny the lack of competition which would lead to lower audit quality, by strongly down-playing the perception of missing competition. Instead, they all argue that mandatory rotation would create the problem of an insufficient level of competition. Because Big Four firms would be the only ones that are able to handle very large audits and rotation would force at least one of them out of the market, concentration in the audit market would further intensify. Through this line of argumentation, they basically flip the claim of too less competition, by firstly denying or down-

¹ They rely on an unpublished working paper from the Bocconi University from 2002. Researchers from Bocconi University have published several studies on the topic of mandatory rotation in Italy in recent years. Unfortunately, I was not able to access the paper from 2002, which might be explained through new studies from SDA Bocconi that partly contradict earlier findings.

playing the perception of too less competition and emphasizing the intensity of the competition with regard to price and fierceness of competitors. It is thereupon followed by the argument of even less competition in case of mandatory rotation, which they again base on research from Italy (Cameran et al., 2015). Using stake inoculation in this context clearly intends to re-legitimize the current situation and de-legitimize mandatory rotation. This stake inoculation strategy can also be related to Suchman's (1995) approach of responding to threats to the pragmatic legitimacy of an organization. Any misbehaviour is denied and pragmatic concerns about missing competition are allayed in order to restore pragmatic legitimacy. By twisting the argument, it is also linked to the use of a stake misalignment strategy to de-legitimize mandatory rotation as a practice that is not aligned with the legitimate interest of society to have broad competition, which the Big Four firms in turn would definitely share.

Stake inoculation, the process to legitimize a certain practice by denying or down-playing the notion of any illegitimate interest or motive in a particular argument or action is also used when the Big Four refer to potentially negative consequences for the audit quality as a result of mandatory rotation. They refer to a high level of audit quality as the ultimate goal of all stakeholders in the process of auditing and claim that mandatory rotation would presumably reduce audit quality and this would force them to argue against it. This understanding is based on the observation that mandatory rotation would initially lead to a loss of firm-specific knowledge, which would subsequently reduce audit quality in the first years.

“There are real benefits to the quality of audit arising from deep institutional knowledge of the business being audited that is acquired by the audit firm, even though the individuals involved change” (PWC).

Mandatory rotation would wipe out this knowledge and various research is used to underline this argument, e.g. U.S. GAO (2003). In addition, it would lead to a loss of industry-specific knowledge of audit firms, which would reduce the audit quality in the long run.

KPMG ultimately links audit quality with the inner values of an audit firm and thereby relies on stake transcendence to create legitimacy for abstaining from rotation. Stake transcendence refers to the claim that any self-interest in a certain action is transcended by aligning to a higher norm, value or ideal. It can be used to present themselves as legitimate by disavowing any personal interest (Whittle et al., 2014). Here it is used to rebut the argument that audit quality has not been the main priority of audit firms anymore and mandatory rotation needs to be implemented to achieve a higher level of quality. KPMG therefore refers to the mindset of audit firms:

“At KPMG we recognise that audit quality is fundamental to our future business. (...), audit quality lies at the heart of our business and is a primary objective of our professionals: the public interest and our own business objectives are fully aligned. (...) This mindset of focusing on audit quality is a powerful counterweight to the risk of independence compromised by over familiarity.” (KPMG)

By emphasizing audit quality as the single most important thing for the firm's survival and the ultimate goal for their employees, they deny any influence through long-term relationships on audit quality. They argue that striving for a high level of audit quality itself already acts as an adequate safeguard against a

skewed handling of long-term clients. Mandatory rotation would not be necessary, because all auditors are already aligned with this higher ideal of audit quality. Here, KPMG relies on stake transcendence to create legitimacy for abstaining from a rotation regime.

Throughout their responses it is also apparent that the Big Four emphasize the existing rules on audit partner rotation in order to apply a stake alignment strategy. Stake alignment refers to the process of claiming to be aligned with the legitimate interests of the broader society (Whittle et al., 2014). Here, all firms acknowledge the risk of familiarity and highlight their ambition to address this risk by emphasizing the requirement to change the audit partner and key members of the team after seven years.

“Current standards effectively minimize any threat of familiarity, because there is systematic and regular rotation of key audit team members” (PWC)

“Rotation of key audit partners, (...), coupled with natural turnover of client personnel keep relationships between the audit firm and audit client fresh, thereby eliminating potential independence concerns” (Deloitte)

According to their line of argumentation, familiarity only arises between individuals, not firms. The obligation to rotate the audit partner and key team members in combination with a common fluctuation within the management of the audited entity are thus sufficient to control the risk of familiarity. Through a constant emphasis on the existing regulation for partner rotation, they try to assure the recipients of their comment letters of their alignment with the public interest to protect the auditor’s independence. Because the expectations of both groups are already aligned, further regulation would be unnecessary.

4.2.2 Audit profession

The arguments put forward in the comment letters of other respondents linked to the audit profession often resemble the arguments of the large audit firms. Nevertheless, there is another emphasis in their responses and it is also remarkable that for instance mid-sized audit firms also oppose mandatory rotation, even though the European Commission explicitly intends to strengthen their position and ability to compete against the large incumbents through regular rotation of large audit mandates.

BDO, Grant Thornton and Mazars as representatives for mid-sized international audit firms which the European Commission wants to enter the top-end audit market all officially reject mandatory rotation. They contend that rotation would not benefit smaller competitors but could result in less competition.

“such practice has resulted in a more pronounced concentration in the audit market, to the detriment of firms outside the largest four firms.” (BDO)

“In terms of concentration, mandatory rotation of firms would only have an impact if it favoured, by way of some form of regulatory requirement, alternative audit firms.” (Mazars)

This support for the stake inoculation strategy of the Big Four firms, which claim that they oppose rotation, because it would further intensify the market concentration, is surprising. But it adds a lot of legitimacy to the current practice, as the presumable profiteers of mandatory rotation question one of

the main goals. It can be seen as using stake misalignment to de-legitimize mandatory rotation, as they claim that proposing rotation is not aligned with the legitimate interest of increasing competition. They also consider partner rotation as a sufficient safeguard, which also supports the stake alignment strategy to re-legitimize current practices used by the Big Four. The mid-sized companies all propose that instead of being subject to a compulsory requirement, the EU shall focus on eliminating the bias towards hiring only Big Four firms to increase competition. From their point of view, stronger corporate governance processes and audit committees are better suited to guarantee auditor independence in the long-term.

“The original intention of this practice was focused on ensuring auditor independence, but since the Italian law was enacted there have been many other developments which better serve to safeguard an audit firm’s independence from its client.” (BDO)

Within the different organizations linked to the audit profession opinions are more diverse than between audit firms. However, the two most influential associations, IDW and FAR both firmly oppose rotation. In their comment letters, they strongly deny that mandatory rotation could achieve the goals illustrated by the EU. In fact, both associations picture a distinct drop in audit quality through compulsory rotation.

“FAR would like to stress that studies (...) have shown negative effects on audit quality” (FAR)

They also reject the belief, mandatory rotation will increase auditor’s independence, describing it as a measure with *“superficial appeal”* (FAR) or as useless compared with the existing rules on internal rotation *“No further advantages of external rotation in comparison to existing rules are evident.”* (IDW). The notion of increased competition is negated with even more emphasis than by the audit firms.

“Any suggestion that this would mean that small-and medium sized audit firms would acquire more audit clients than they would relinquish, is unsubstantiated.” (IDW).

They also emphasize that rotation would further increase fee pressure on audit firms, which they see as a bigger threat to audit quality. This explicit opposition illustrates a stake misalignment strategy. Stake misalignment is used to de-legitimize a certain activity by claiming that an individual or group is not aligned with a legitimate set of interests (Whittle et al., 2014). Here, both associations claim that the new regulation is not aligned with the legitimate interest to enhance quality and increase competition and thus aim to reduce legitimacy for it. Their line of argumentation can also be related to the strategies identified by Suchman (1995). They use a combination of both, deny and justify strategies, in order to respond to the legitimacy threats raised by the European Commission and deploy these arguments in order to restore pragmatic and moral legitimacy. Yet, these associations represent the audit profession, which explains their strong opposition, because it is in their own interest to picture themselves as already aligned with society’s expectations. They must display the current practices as an effective instrument to protect the interests of society in order to protect the legitimacy of the audit profession itself.

On contrary, some smaller associations provide slight support for mandatory rotation. They argue that according to the self-perception of the Big Four, a drop in client- or industry-specific knowledge due to rotation should be absorbed rather quickly as they present themselves as the best choice for large audits.

“there cannot be an argument that knowledge is lost in case of audit firm rotation” (DWV)

However, both DWV and SRF as the only slightly supportive representatives of the audit profession argue that compulsory rotation of audit firms would only be useful for financial or public-interest entities which could be of systemically relevance, as they otherwise still share the fear of a drop in audit quality. This line of argumentation seems to some extent inconsistent, as they do not explain why it is positive for public or financial entities and on the opposite negative for other private firms.

4.2.3 Preparers and users

Among the group of preparers and users of financial statements opinions are rather split, even though there is still a strong tendency to reject mandatory rotation. The German Trade Union Confederation (DGB) for instance argues that they have demanded mandatory rotation for several years due to concerns about the independence of auditors and limited competition. The CFA Institute mentions the expectation gap between the public and auditors and the Swedish Banking Association argues that a mandatory rotation regime could increase the confidence of the users of financial statements, even though they don't differentiate between external and internal rotation. All of them justify their support more or less implicitly through using a stake misalignment strategy and claiming that auditors are not aligned with the legitimate expectations of society towards their role.

On the contrary, Fraport AG as an individual company opposes rotation on the ground of already sufficient regulation regarding internal rotation and the cost increase that occurs from mandatory rotation. This claim is supported and backed by the Swedish Shareholders' Association, the Confederation of Swedish enterprises, the DAI and NASDAQ OMX, which all oppose rotation and emphasize costs, negative influence on audit quality and sufficient independence through partner rotation. Some also base their opposition on their understanding that mandatory rotation will interfere with corporate governance procedures and the shareholders right to choose the auditor.

“We think that a mandatory rotation of audit firms also contradicts the shareholders right to appoint the auditor which they believe will appropriately fulfil their requirements.” (DAI)

Here, a stake alignment strategy to re-legitimize the current procedures is used again. It is based on the perception that it is the general interest that shareholders are in charge of appointing the appropriate auditor. At the same time this argument displays the commission's approach as misaligned with the legitimate interest of society to let shareholders decide about the choice of auditor and can be regarded as using stake misalignment to de-legitimize the new regulation.

4.2.4 Academics and others

Among the academic institutions the overall picture of mandatory rotation is the most positive of all groups participating in the consultation process. There is a slight tendency to support rotation, although some are still concerned about it. However, their comment letters in conjunction with those from very

different other directions offer a good picture about the arguments brought up by opponents and proponents and by this highlight some of the strategies used to gain or reduce legitimacy in the discourse.

The Goethe-University acknowledges the positive influence of longer audit tenures for knowledge and understanding of the audited entity, but still highlights the benefits for the independence of audit firms from rotation. Even though they do not officially support a requirement to rotate the auditor, they argue for a requirement of regular tendering every 3-5 years. This in fact can be seen as an argument pro rotation due to the implicit understanding that this will lead to more frequent changes of the audit firm, which would be beneficial for audit quality and auditors' independence. The Max-Planck-Association also delineates the potential implications of mandatory rotation and weighs benefits and costs to finally conclude that rotation needs to be implemented. They use stake interrogation to de-legitimize long-term relationships by questioning the legitimacy of the auditors' interest in those relationships:

“while auditors may consider themselves independent, the mere fact that they need to please the management of the audited company in order to secure the re-engagement for the subsequent year introduces a bias into their judgment.” (Max-Planck-Association)

By simply concluding that even though auditors might not be explicitly aware of it, the nature of the contract will influence their behaviour, they question the legitimacy of the actions undertaken with such a biased behaviour and subsequently create legitimacy for new regulation to overcome this bias. They continue by using stake attribution to rebut arguments that the existing rules on internal rotation are sufficient. Nearly all representatives of the audit profession used stake alignment strategies by drawing on partner rotation as a sufficient safeguard to protect the auditor's independence. Here, the Max-Planck-Association argues that internal audit partner rotation by no means can be used to display alignment of society's interests and auditors' values.

“The incentives (...) to maintain the audited company as a client remain the same after the implementation of the internal rotation: The lead audit partner must ensure that the client is not lost. While audit firms may not be dependent on individual clients, the individual partners, and their standing within the audit firm will depend very much on whether they lose one of the few clients they personally serve.” (Max-Planck-Association)

They carve out the discrepancies in the argument, which is widely used throughout the comment letters. They thereby accuse auditors of an illegitimate interest in maintaining their client, which refers to a stake attribution strategy to de-legitimize current practices.

In addition, strong support for the implementation of a rotation regime comes for instance from Transparency International, an international NGO based in Germany, which mostly fights against corruption. They claim that only frequent change ensures 'real' independence as everything else would lead to wheeling and dealing amongst clients and auditors and they highlight the social duty of auditors:

“We believe the societal role of the auditor needs reemphasizing in the profession so that the obligation to measure performance against the expectations of society is constantly in focus.” (Transparency Inter.)

In a similar tone BearingPoint, the former KPMG consulting branch and now independent management consulting firm, demands the European Commission to take all necessary measures to break up the market dominance of the audit firms, even though they mostly complain about expansions in the advisory sector. But also other parties like the German Institute for Internal Revision support rotation, as they agree this would have an effect on the auditors' independence.

However, despite the support from parts of the academic respondents and industry watchdogs, both governments from Sweden and Germany formally oppose the implementation of mandatory rotation in their statements to the EU. This is powerful support for the legitimacy of the audit profession, as it assures them that they still possess the trust of the majority of the domestic politicians. Both governments emphasize the costs and potentially negative consequences for audit quality. Furthermore, they highlight that they do not see any need to reconsider mandatory rotation due to the financial crisis.

“such a requirement would result in increased costs for the audited companies. (...), and, therefore, also disrupt the continuity and quality of the audit process as a whole.” (Swedish government)

“However, it has to be taken into account, (...), that inadequate audit quality can not be considered as the reason for the financial crisis.” (German government)

This is a strong backing for the legitimacy of the audit profession itself, because it ultimately supports the claim of the auditors that the financial crisis was not the result of an audit failure and that the auditors did provide correct statements during the crisis, which were not biased by an overly close relationship to long-term clients. It also supports the Big Four firm's strategy of mainly using stake alignment strategies to present themselves as aligned with the expectations of society.

4.3 Interviews

The interviews were conducted with three audit professionals and one member of the advising group for the Swedish government (hereafter business representative). Two of the auditors work for the Big Four and one for a smaller competitor. I use their responses to identify how they evaluate the current situation and the introduction of mandatory rotation with a focus on the arguments which they brought up. By linking their arguments to the findings from the document analysis, I try to further substantiate and verify the strategies used to create and protect legitimacy within the comment letters.

In general, there is a tendency to oppose rotation among the interviewees, which supports the claim of the audit profession that mandatory rotation is an ill-advised instrument to fix a non-existent problem. Their line of argumentation is still different. The business representative argues that the implementation was triggered by a questionable assumption of increasing audit failures during the financial crisis.

“I think, the legislation and politicians have taken a shortcut to say, if the banks are run out of money, there must have been something wrong, a problem with the audit. But that has never been proven. So the whole political stage for this reform was based on an assumption that I don't think has been scrutinized enough.” (BR)

His point of view strongly resembles the position both governments have taken during the discourse, which tried to protect the legitimacy of the current status by questioning the motive of the EU to implement rotation. This can be regarded as a stake interrogation strategy. It basically criticizes the perception of a lack of independence and competence in the audit profession and downplays general concerns about auditors to some extent, as it questions the underlying reasons for the reform.

The Big Four auditors focus more on audit quality. They mention rising quality throughout the years and the problems with new audits, where they have to begin with collecting knowledge about the firm.

“After every year you analyse what went good and what went bad during the audit. What advice can we give to the clients in order to make the audit more efficient next year etc. This is done every year, audit should develop and so is the quality of the audit throughout the years.” (A1)

From their point of view, rotation would destroy deep institutional knowledge, which would harm audit quality and increase costs for all parties. This in line with the discursive strategies and argumentation in the comment letters and throughout the interviews the challenge of understanding the business was repeatedly highlighted as one of the key parts of the business, also by the non Big Four auditor.

“Having a good and long-time working relationship, that is just good, because then you get to know the company and you understand the business, which is the hardest part of audit.” (A3)

Emphasizing the positive characteristics of a long-term relationship can be regarded as a strategy to justify the opposition in order to gain legitimacy for long-term relationships. It is linked to the stake inoculation strategy of the Big Four firms in the comment letters, which emphasize the negative characteristics of rotation on quality to achieve legitimacy for their opposition towards the regulation.

However, the interviews display the discrepancies among the respondents' perceptions of how mandatory rotation will influence auditor's independence. While the business representative argues that rotation can in fact increase the ability of the auditor to act independent, he also tends to neglect that auditor independence generally needs to be increased in Sweden.

“companies having a strong board of directors, who appoint the auditors, compared to the ones with more control by the shareholders, you don't need that much regulation the latter.” (BR)

Due to an ownership structure with many active majority owners and strong corporate governance rules the Swedish environment already sets high demands towards independent auditors. The other respondents argued that auditor independence in Sweden is already sufficient. Or as one auditor claims:

“I don't think the issues have been as urgent in Sweden as they have been in other countries.” (A1)

The reform therefore will not affect practitioners that much in countries with similar regulations and culture like Sweden. However, the tenor from all interviews was that the overall reform might help the audit profession to improve its independence in appearance towards stakeholders. More independence in appearance would then add substantial legitimacy to the audit practices and profession itself and can be seen as an argument pro rotation.

With regard to the third main objective of the European Commission all respondents were concerned that the regulation in fact will have the opposite effect and further intensify the market concentration in the top-end audit market. Although this resembles the argumentation of a lot of the opponents, the interviews add further legitimacy against the regulation as this perception is also shared by the respondent from a non Big Four firm and the business representative. This is remarkable as the non Big Four auditor appreciates the opportunity for smaller firms but is not convinced it will have this effect:

“Well, for us it is an opportunity to get into those clients. (...) Because, that is, (...), you always here from bigger clients ‘well, your proposal looks better than the others, but maybe the outside environment still thinks it has to be Big Four’.” (A3)

From her understanding, the regulation might miss the mark as the competition is hindered more by the perception that only Big Four audits add legitimacy to the client’s financial statements, rather than by the lack of tendering possibilities for non Big Four firms.

“But if the listed companies will still think that ‘no, we can’t have anyone else than the Big Four’ then it will have no effect at all. So, I think it is more important how they think, then when and which firms are allowed to tender.” (A3)

Remarkably, also the business representative concludes that the reform will not increase competition in such a small market in Sweden, although he argues that it is other factors including entry barriers or knowledge issues in combination with the reputation factor that hinder other firms to get into the market.

“The problem is that the entry level, the barrier for other firms to enter the market is so high. The knowledge issue, requires enormous investments, and so on..” (BR)

If firms still not consider other audit firms than the four largest it will inevitably limit the choice of auditor, especially in combination with the new regulation on the provision of non-audit services.

“the idea itself is good to try to increase competition and have more firms, but in reality the market structure as it looks, this combined with rotation we will have a drawback.” (BR)

Thus, he also supports the claim that mandatory rotation will not fulfil the objective of increased competition. This is shared by the Big Four auditors, although they feel only Big Four firms are capable of the largest audits and this would be the reason for further concentration then.

“To push towards Big Four territory requires so much supporting activities directed towards audit, legal and IFRS knowledge at a high level is very complicated and necessary. There are very competent auditors at these firms, who indeed are able to conduct the audit but the supporting activities and organizational strength is too weak compared to us.” (A1)

By emphasizing that the market concentration is based on several other reasons and rotation would not address those issues all respondents support and verify the stake misalignment strategy of the audit profession to claim that mandatory rotation will not establish more competition and will miss its intended objective.

5. Further Analysis

In this section the main findings are further analysed as well as connected to previous research on mandatory rotation and the potential implications of the reform in Germany and Sweden are displayed.

5.1 Objectives of the reform

The European Commission aims to achieve the following key objectives through mandatory rotation:

- ensuring and enhancing audit quality
- reinforcing and improving the independence and professional scepticism of auditors and
- spurring competition and making the top end of the audit market more dynamic.

However, the findings from the document analysis and the interviews reflect the ambiguity of the regulation. In general, the responses show a tendency to dispute the positive influence of mandatory rotation and emphasize the costs that would be imposed on businesses. The arguments are presented and linked in the previous section to the discursive strategies identified by Whittle et al. (2014) to illustrate how they are used to create legitimacy for and against mandatory rotation. They are now set in the wider context of the existing literature on rotation and examined with regard to the objectives of the regulation.

5.1.1 Audit Quality

One of the major arguments used for and against the implementation of mandatory rotation is the level of audit quality. On contrary to the commission, which proposes an increasing level of audit quality through the reform, most of the comment letters base their opposition towards rotation on a drop in quality in the first years of an audit. It is the most used contra-argument in the selection of responses: nearly 90% of the negative responses base their opposition at least partly on this argument (Appendix 5). Rotating the auditor would lead to a loss in knowledge that would impair the overall quality of the audit in a second step. Most respondents therefore rely on research from Bocconi University, which depicts a lower audit quality in the first years. This is also supported by several other researchers (Johnson et al., 2002; Stanley & DeZoort, 2007; Carcello & Nagy, 2004; George, 2004). It seems inevitable that the rotation requirement will reduce audit quality in the first years after the change and the argument is successfully used to gain legitimacy against mandatory rotation.

For all that, it still seems an intriguing argument since at the same time all audit firms are always eager to win new clients and start new engagements on a regular basis. The interviewed auditors highlighted that it is a usual task for any audit firm to acquire and handle new clients, even though new engagements pose a challenge in the beginning. In addition, all Big Four firms present themselves in their responses to the commission as the sole survivors of fierce competition in the market and their clients would choose them due to their unique abilities, deep institutional knowledge and efficient structures.

“These large complex and global businesses need large, technically advanced, global auditors. High concentration levels which are cited by the Commission therefore reflect market choice and it is a fiercely competitive market.” (KPMG)

If the Big Four firms have such a self-perception this should in turn be reflected in their argumentation about quality. It seems intriguing that the audit profession and especially the Big Four firms on the one hand display their high standards and capabilities while they argue on the other hand that if they acquire a new mandate, the audit quality will substantially drop and cause the risk of multiple audit failures.

Throughout the interviews all auditors highlighted their efforts to make the audit more efficient and effective every year through reassessments and evaluation of the previous work. Audit quality in later years should therefore not be impaired, which is also supported by research that points out that the perceived audit quality increases with longer audit tenure (Mansi et al., 2004; Gosh & Moon, 2004). This continued improving of the audit processes is then used to gain legitimacy for long-term relationships. Still, there is lacking evidence for a perennial increase in audit quality (Lennox et al., 2014). It seems plausible that during the years the focus of the auditor is rather on improving the efficiency than the effectivity of the audit, which for instance one interview might verify.

“if you have worked with a client for many years, you might become more inclined to raise your number of materiality” (A1)

Although research tends to link longer audit tenures with a better perceived audit quality (Mansi et al., 2004; Ghosh & Moon, 2004), research on actual audit failures is usually not differentiating after seven-nine years anymore (e.g. George, 2004; Johnson et al., 2002). This study suggests that it is questionable, if there is still substantial improvement in audit quality after a certain amount of years. Based on German data, this issue has also been mentioned by Quick & Wiemann (2011) and recent research from Hohenfels (2016) indicates that perceived audit quality reaches its maximum after 8-9 years audit tenure and is declining afterwards. Therefore, it would be necessary to examine the difference in audit quality between longer periods (> 20 years) and e.g. periods between 10-20 years. Noteworthy, new research has also emerged during the discourse in this context. While being previously the academic base for the opponents of rotation, the most recent study from Italy identifies an increase in the audit quality in the preceding years before the rotation comes to force and concludes that the rotation requirement has an overall beneficial effect on audit quality in Italy (Cameran et al., 2016). The presumably inevitable drop in audit quality in the first years might therefore be compensated by an increase in audit quality in the later years. Even though future research is necessary to verify both claims, the recent findings from Italy together with Hohenfels (2016) results indicate that rotation can increase the overall audit quality.

These findings add a substantial amount of legitimacy for a rotation requirement, because the argument of lower audit quality does not hold stand over the whole period of the engagement, as auditors are very seldom changed before the end of the rotation period (Cameran et al., 2016). By changing the rotation period from the initially proposed six years to ten years the EU has reacted to the claims from the audit profession. The opponents gained legitimacy with their argument of lower quality in the first years, because it is supported by academic research. However, this argument loses steam in the discourse and legitimacy is created for the reform by balancing the argument against the reality of the audit market. The stake misalignment and stake attribution strategies applied by the commission during the discourse

in combination with recent research create enough legitimacy to overcome the widely used argument that audit quality in fact declines through rotation.

5.1.2 Auditor independence and professional scepticism

The second main objective of the European Commission is to reinforce auditor independence and professional scepticism. According to their point of view, limiting the audit tenure impedes overly close relationships and implements an actual safeguard against the threat of familiarity. It reduces the incentives to please the client and strengthens the auditors' ability to critically appraise and interpret financial statements. Their line of argumentation is amongst others based on research from Dopuch et al. (2001), which argue in favour of mandatory rotation as their research implies that the non-existence of such a regime leads to more cases of compromised independence. This claim is also supported by research from Wang & Tuttle (2009) and the commission refers to this studies in order to achieve legitimacy for mandatory rotation as it shows that professional scepticism could be improved by it.

Yet, this might be a rather weak foundation for their argument. Both studies are experimental quantitative studies, which might incorporate some shortcomings. Dopuch et al. (2001) relied on business students to assess the effect of rotation by analysing the willingness to issue an audit report in favour of the management. This setting might be misleading, as in reality a multitude of other factors, regulations and values influence the auditors' decision and none of this is acknowledged in that setting. In fact, most of the research supporting rotation because of its influence on auditor independence is based on experimental settings (Dopuch et al., 2001; Wang & Tuttle, 2009; Gietzmann & Sen, 2002) and lacks an understanding for the complexities that affect it in a real-world setting. According to this study, it will be rather difficult to see the influence on the independence in mind caused by the implementation of mandatory rotation, at least in countries like Germany and Sweden.

This is shown by the broad opposition from other groups than the audit profession in both countries, which firmly reduces the legitimacy of the new regulation. It displays that at least investors and businesses in Germany and Sweden do not experience significant problems with auditor independence. One potential explanation for this could be country-specific characteristics of those two countries. Both countries have a very similar accounting tradition as well as they transposed the EU reform similarly into national law. The ownership structure in combination with the corporate governance structure might help to understand the importance of regulations. In both countries shareholders are in comparison rather strong and might reduce the need for regulation, which is also pointed out by researchers from Italy (Cameran et al. 2016). In comparison to other countries in the EU, both legal environments are arguable also very strong and the litigation risk is high (Leuz et al., 2003) which will influence the auditor's decision-making to a great extent and presumably strengthens the auditors' position in both countries. This might also explain, why both governments argued against rotation and thus substantially reduced the legitimacy of the new rules. This observation is also shared by the Swedish practitioners, which assumed from their position that the reform will rather have an effect in other countries with less cultural

awareness for auditor independence. Recent research supports these arguments, as longer audit tenures seem to impair auditor independence for instance in Greece (Rickett, Magina & Alam, 2016).

Even though the European Commission and other supporters of mandatory rotation have difficulties to raise legitimacy for the positive effect of it through claiming a strengthened independence in mind, there is no doubt that the independence in appearance is increasing through the new regulation. Independence in appearance refers to the auditor being seen as independent by other individuals. Mandatory rotation as a rule with “*superficial appeal*” (FAR) appears rather straightforward and simple for most people and was demanded by industry watchdogs, business critical organizations and a couple of politicians with great determination as it was apparent from the comment letters. Also the Big Four acknowledge the potential for the independence in appearance and all respondents from the interviews agreed that at least the independence in appearance is presumably improved.

“we recognise that limiting the continuous engagement of the audit firm might increase some stakeholders’ perceptions of independence.” (KPMG)

The regulation therefore gains legitimacy through a likely increase in the overall auditor independence due to an increase in the independence in appearance, which has also been supported by research from Daniels & Booker (2011). This in turn also adds legitimacy to the audit profession itself, as it assures mainly the general public of auditing being aligned with the expectations of society and by this the regulation aims to narrow the identified legitimacy gap. The opponents of mandatory rotation were able to protect the legitimacy of the current practices through their stake alignment strategies and the research on auditor independence tends to support their argument of a lack of effects on the independence in mind. However, the effect on independence in appearance might even be stronger and thus creating legitimacy for the audit profession.

5.1.3 Competition

When it comes to the implications on competition, opinions between the EU legislators and the audit profession are absolutely contrary. The commission expects movement in the audit market and pictures strong opportunities for more competition. On contrary, the audit profession delineates less competition and even more dominance of the Big Four as a consequence of mandatory rotation. They rely on the experience from Italy, where the concentration has even intensified, even though this can also be explained by a general trend towards more concentration in the last decade (Cameran et al., 2016). But it was apparent from the interviews that there might be a trend towards more strategic decisions about which type of service the audit firms want to provide to a certain client, as the reform also contains prohibitions on non-audit services. The difference in fee income between the different services might lead a particular firm to forego an audit tender in favour of advisory services provided in the same period. This in combination with the mandatory absence of the previous auditor reduces the choice for businesses even more as they if they are not willing to choose an auditor other than the Big Four firms.

In this context, it is thus surprisingly that also all medium-sized audit firms oppose the new regulation in their comment letters, which was repeated in the interview with a non Big-Four auditor. From their understanding, mandatory rotation could open up opportunities, but the general perception to favour Big Four firms would not be addressed and therefore it would not help them to gain market shares. Even though it was not mentioned in their written responses, the issue for medium-sized firms is the possibility of losing their rare large clients due to the rotation rule but not winning new ones. This would result in a drawback of the regulation, as it was mentioned in the interviews. They emphasize that rather instead of more possibilities to change the auditor, the perception of Big Four firms as the sole source of legitimate audits has to be changed in order to stimulate competition. The opposition of these firms diminishes the legitimacy of the mandatory rotation rule to a great extent, because the commission has explicitly mentioned them as the profiteers of mandatory rotation. But if they oppose it as well, this contradicts the argument of the EU and subsequently reduces the legitimacy of the new regulation.

5.2 Costs of mandatory rotation

One of the main arguments to de-legitimize mandatory rotation is the cost burden that would be imposed on businesses. Nearly half of all negative responses in the selected comment letters explain their opposition partly due to the cost increase for the audited entity (Appendix 5). It is particularly arduous to measure the impact the reform will have on the cost level, but all parties including the European Commission acknowledge rising costs. According to the commission it is not possible to quantify the costs for the audited entities due to the dependence on various characteristics of the PIE's. They claim that any initial cost increases due to the knowledge transfer to the new auditor might be offset by lower fees in the second tendering period and less audit failures.

However, recent research estimated the effect of mandatory rotation on audited entities in the U.S. and concludes that the cost increase will be enormous (Gerakos & Syverson, 2015). Although their research is based on the U.S. audit market, their findings can be transferred to a European setting as both markets experience a similar dominance of Big Four firms. Their findings delineate a strong increase in costs, even though the increase might be lower in Germany and Sweden where it is possible to extend the rotation period for another ten years through a tender process. This tender process leads to increased costs for the audited entity and the audit firms, but presumably lowers the proposed audit fees of the incumbent in the second term of the period. The interview partners explicitly also mentioned that further price pressure will result in more negative effects on audit quality. Nevertheless, it is noteworthy to say that the European Commission does not explicitly expect cost benefits from the regulation, which strengthens the argument of the audit profession and shareholder representatives. The legitimacy of the rotation requirement might incur lasting damage through this argument and the cost factor might ultimately decide about the success of the reform.

6. Concluding Discussion

This section presents and summarizes the main conclusions drawn from the analysis. The chapter finishes with further suggestions for future research.

6.1 Findings

It is the first time that mandatory audit firm rotation is introduced on a greater scale. It has thus sparked a fierce debate about its implications for auditors and businesses. After all the European Commission has not been able to gain enough legitimacy for their initial proposal of a six years rotation period and the discourse about the regulation as well as the actual transposition into national law have softened the reform to a great extent in Germany and Sweden. This can be regarded as a sign that the discursive strategies of stake attribution, stake interrogation and stake misalignment that the European Commission used to de-legitimize the current practices could not convince a broader audience of mandatory rotation. The audit profession gained broad support from other groups for their stake inoculation and stake alignment strategies and was able to re-legitimize their practices. In consequence, the commission allowed all member states to choose if they implement additional options that alleviate the rotation requirement by extending the timeframe. This can be seen as a concession to the critique and a sign for the convincing line of argumentation of the audit profession.

According to Suchman (1995) cost-benefit evaluations or ethical judgments accepted by the wider society are often made through public discourse, in which organizations achieve pragmatic and moral legitimacy for their arguments through intense participation. The document analysis and the interviews display that the audit profession firstly relies on the broad support from other stakeholders and secondly deploys some of the strategies identified by Suchman in their fairly successful attempt to resist the rotation threat and to regain legitimacy for their traditional practices. For instance, denying any lack of competition within the audit market can be regarded as a strategy to regain pragmatic legitimacy. Furthermore, the constant references of the profession to a drop in audit quality and sufficient existing rules on internal rotation seem to justify the resistance against the new regulation, which is related to the strategy of repairing moral legitimacy. (Suchman, 1995) This resemblance to Suchman's strategies can be seen as the profession's approach to respond to the legitimacy threat raised by mandatory rotation.

With particular regard to Germany and Sweden, the implications of the reform appear rather vague. Both countries are characterized by their strong corporate governance structures and a comparably strong cultural awareness for ethical behaviour, which reduces the need for additional regulation on auditors' independence. The interviews suggest that other EU countries with a weaker legal environment might experience a comparatively stronger impact on auditor independence through mandatory rotation, which has recently been supported by Cameran et al. (2016) and Rickett et al. (2016) as well.

The study also suggests that the influence on the auditors' independence in mind seems insignificant in both countries. This is in contrary to previous experimental research (Dopuch et al., 2001; Wang & Tuttle, 2009), on which the European Commission amongst others based its stance of proposing the

regulation. However, the study indicates that the auditors' independence in appearance will be enhanced, also because support for mandatory rotation is mostly shown by representatives from the general public. This can reduce the identified legitimacy gap between public expectations and the audit profession, which would benefit both sides. On the contrary, costs for the audited entities are clearly increasing through the reform as it is also shown by Gerakos & Syverson (2015), who claim that a rotation requirement will entail costs similar to the market exit of a Big Four firm. It is therefore questionable if the benefits of an increased independence in appearance outweigh the costs of a rotation requirement.

In addition, the rotation requirement could lead to adverse effects which foster further market concentration in the top-end of the audit market and contradict the third main objective of the reform. This study shows that on contrary to the expected perception, medium-sized audit firms do not favour mandatory rotation in order to achieve greater competition and by this substantially reduce the legitimacy for the regulation. Rather than expecting a significant increase in new clients, they blame a bias for the Big Four firms as the biggest problem in the top-end of the audit market. As research focuses to a great extent on the effect of rotation on auditor independence and audit quality (Lennox et al., 2014) and is rather scarce about the implications on competition this study suggests that the the objective of increased competition should be scrutinized more in order to assess the overall impact of the regulation.

The combination of mandatory rotation and prohibition of non-audit services might also affect the market conditions in other undesired ways. It can lead to more strategic decisions from the large audit firms about what service they prefer to offer to which client and eventually further reduce competition, because after all large clients tend to favour and hire only Big Four firms.

However, there is still the possibility of eventually less but more diverse audit firms participating in the tendering process for large audit mandates. Even though rather the undesired consequences are emphasized throughout the document study and interviews, only the future can reveal the actual effect on competition.

6.2 Contribution

The study draws on Whittle et al.'s (2014) framework of discursive strategies and depicts how the different actors frame their arguments in the process of gaining legitimacy for and against the new regulation. Although the European Commission deploys all three different strategies identified by the framework, they cannot create a compelling case for mandatory rotation. The opponents rely mostly on stake inoculation and stake misalignment strategies in order to structure their line of argumentation against mandatory rotation. Through broad support for their strategies, they are able to mitigate the consequences of the reform and both countries implemented the longest possible rotation periods. By highlighting the strategies and arguments this study establishes a better understanding of the discourse about mandatory rotation. It suggests that the debate is not only about facts and figures but also about the legitimacy of mandatory rotation and the audit profession itself.

Furthermore, the study delineates the potential implications of the reform with a focus on Germany and Sweden. Mandatory rotation might have been a first attempt to restrict further market concentration and initially causes discontent among businesses. But so far, the audit profession in both countries managed to re-legitimize their practices to a great extent and diluted potential consequences of the reform. This also means that a reliable assessment of the implications in both countries will only be feasible with the benefit of hindsight. However, this study reveals that the implications for auditor independence in mind in Germany and Sweden might be rather vague due to the already existing strong legal enforcement and regulation on this issue. The findings suggest that the implications of the regulation are more pronounced in countries with a weaker legal environment and less awareness for the familiarity threat. The study also indicates that mandatory rotation could result in negative consequences for competition rather than encouraging more competition, due to strategic decisions from the Big Four firms about which services will be offered to which client and the tendency to still not include more audit firms in the tender process.

6.3 Future research

If there is one thing everyone participating in the debate on mandatory rotation can agree on, then it is the fact that only future research will reveal the true consequences of it. Certainly, quantitative research about the influence of the EU reform on auditor independence, audit quality and audit fees will be needed to evaluate the success of the regulations in a couple of years. However, this could be supplemented by qualitative research on how investors and preparers assess the impact of mandatory rotation in Eastern European countries compared with Scandinavian countries or Germany, because this study suggests that the effect in countries with a weaker legal structure could be far more intense. Furthermore, research about how the audit profession reacts to other threats to their legitimacy like the trend towards more digitalization or even more state intervention would reveal interesting insights about the changing audit landscape. As it is a complex set of interrelated actions and practices through which the audit profession gains legitimacy for their activities it would also be interesting to further investigate certain aspects of it, e.g. how legitimacy for CSR or integrated reporting is created through public discourse.

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Appendix 1

Selection of documents released by the European Commission and associated bodies

Number	Date	Type	Name
1	13/10/10	Green Paper	Green Paper - Audit Policy: Lessons from the Crisis
2	13/10/10	Memo	The European Commission consults on how the European audit market can be improved - European Commission
3	04/02/11	Green Paper	Summary of responses - Green paper - Audit policy: Lessons from the Crisis
4	30/11/11	Proposal	Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts
5	30/11/11	Working paper	Commission staff working paper - impact assessment
6	30/11/11	Press release	Restoring confidence in financial statements: the European Commission aims at a higher quality, dynamic and open audit market - European Commission
7	30/11/11	Memo	Reforming the Audit Market - Frequently Asked Questions
8	17/12/13	Memo	Commissioner Michel Barnier welcomes provisional agreement in trilogue on the reform of the audit sector - European Commission
9	03/04/14	Statement	European Parliament backs Commission proposals on new rules to improve the quality of statutory audit - European Commission
10	03/04/14	Memo	Reform of the EU Statutory Audit Market - Frequently Asked Questions
11	14/04/14	Press release	Council adopts legislative package on the reform of the audit market - Council of the European Union
12	15/04/14	Memo	Economic review of the financial regulation agenda: Frequently asked questions - European Commission
13	16/04/14	Regulation	Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC
14	16/04/14	Directive	Directive 2014/56/EU of the European Parliament and of the council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts
15	23/05/15	Speech	Contribution of the audit to the capital markets union - Jonathan Hill
16	17/06/16	Press release	New EU rules to promote high-quality audits take effect - European Commission

Appendix 2

Selection of comment letters submitted during the discourse

Number	Name	Type	Country	Mand. Rotat.
1	Arbeitskreis Bilanzrecht - Rechtswiss.	Academics	Germany	Oppose
2	BDO	Audit profession	Multinational	Oppose
3	BearingPoint	Others	Multinational	No opinion
4	Bundesarbeitskammer	Users	Germany	Supportive
5	Bundesverband Deutsche Industrie (BDI)	Preparers	Germany	Oppose
6	CFA Institute	Users	Multinational	No opinion
7	Confederation of Swedish Enterprises	Preparers	Sweden	Oppose
8	Deloitte	Audit profession	Multinational	Oppose
9	Deutscher Gewerkschaftsverband (DGB)	Users	Germany	Supportive
10	Deutscher Industrie- und Handelskammertag (DIHK)	Preparers	Germany	Oppose
11	Deutscher Wirtschaftsprüferverein (DWV)	Audit Profession	Germany	Slight support
12	Deutsches Aktieninstitut (DAI)	Users	Germany	Oppose
13	Deutsches Institut für Interne Revision	Others	Germany	Slight support
14	ESCP Europe Business School (ESCP)	Academics	Germany	Supportive
15	EY	Audit profession	Multinational	Oppose
16	FAR	Audit profession	Sweden	Oppose
17	Fraport AG	Preparers	Germany	Oppose
18	German Government	Public Authorities	Germany	Oppose
19	Goethe-University	Academics	Germany	Oppose
20	Grant Thornton	Audit profession	Multinational	Oppose
21	IAASB	Professional Body	Multinational	No opinion
22	IDW	Audit profession	Germany	Oppose
23	IESBA	Professional Body	Multinational	Oppose
24	KPMG	Audit profession	Multinational	Oppose
25	Max-Planck-Association - International Law	Academics	Germany	Supportive
26	Mazars	Audit profession	Multinational	Oppose
27	Ministry of Justice of Sweden	Public Authorities	Sweden	Oppose
28	NASDAQ OMX	Preparers	Sweden	Oppose
29	National Audit Office of Sweden	Professional Body	Sweden	No opinion
30	Nordic Federation of Accountants (NRF)	Audit profession	Sweden	Oppose
31	PriceWaterhouseCoopers (PWC)	Audit profession	Multinational	Oppose
32	RN	Professional Body	Sweden	No opinion
33	Swedish Accounting Consultants (SRF)	Audit profession	Sweden	Slight support
34	Swedish Banking Association	Preparers	Sweden	Slight support
35	Swedish Corporate Governance Board	Professional Body	Sweden	Oppose
36	Swedish Shareholders Association	Users	Sweden	Oppose
37	Transparency International (TI)	Others	Multinational	Supportive
38	University Würzburg	Academics	Germany	Oppose
39	Vertreter DAX Prüfungsausschüsse	Preparers	Germany	Oppose

Appendix 3

Interview Guide



1. What is auditor independence in your perception?
- Has your view on auditor independence changed during your career?
2. What do you think is the biggest threat towards auditor independence?
- Have you perceived any of these threats in your career? Can you give an example?
3. What do you think about the EU audit reform in general. Will it enhance auditor independence?
- Do you think the implemented measures are addressing the right issues?
4. What are your perceptions of mandatory rotation of audit firms?
- Can you agree with the European commission that an auditor is not independent anymore after more than ten years relationship with the client?
5. What are your perceptions of mandatory rotation of audit partners?
6. Do you see any negative impacts, or obstacles, due to mandatory audit firm rotation for the affected companies?
7. Do you see any negative impacts, or obstacles, due to mandatory audit firm rotation for the affected audit firms?
8. What benefits do you expect from the mandatory audit firm rotation?
10. How would you say that the duration of an auditor tenure affects the independence of an auditor?
- ex. do you agree that a longer auditor tenure is synonymous with a decline of auditor independence?
11. How would you say that the duration of an auditor tenure affects the quality of a financial report?
- Do you think rotation might lead to a decline in quality?
12. According to research, audit quality might increase in the last two years of the rotation period. Can you agree to the argument that auditors might be less reluctant to provide critical evaluations?
13. Do you expect increased competition in the audit market due to the reform?
- 14a. Do you think the EU reform will affect the business model of the Big Four firms?
- 14b. Do you think the EU reform will open up opportunities for your firm?
- Do you expect to win clients due to the rotation rule?
15. Do you think the current regulation assures sufficient auditor independence? Are there any suggestions that you have?

Additional questions to business representative

1. What were the reasons for the expert group to argue for the extension of the rotation period?
2. Will the EU audit reform affect the Swedish Market in other ways?
3. From your point of view, what do you think is the best way to maintain auditor independence?
- ex. mandatory audit firm rotation, an autonomous audit committee within the firm, etc.

Appendix 4

Transposition of EU audit reform in German and Swedish regulation

EU baseline regulation 	Options for member states	German / Swedish approach  
<ul style="list-style-type: none"> • Rotate audit firm after maximum of 10 years • Minimum initial engagement one year 	<ul style="list-style-type: none"> • Extend rotation period to: <ul style="list-style-type: none"> • 20 years if tendering process is conducted • 24 years in case of a joint audit agreement 	<ul style="list-style-type: none"> • Member state option was applied • All PIEs with exception of banks and insurances can extend duration period by conducting tender / joint audit • Banks / Insurances are forced to rotate after ten years
<ul style="list-style-type: none"> • Rotate key audit partner after seven years 	<ul style="list-style-type: none"> • Impose stricter rotation period 	<ul style="list-style-type: none"> • Audit partner are still rotated every seven years; no tightening
<ul style="list-style-type: none"> • Prohibition of certain non-audit services to audited entity (as listed in regulation) by statutory auditor or audit firm 	<ul style="list-style-type: none"> • Add further services to list of prohibited non-audit services • Permit certain tax-services 	<ul style="list-style-type: none"> • Option to add further services is not chosen by both countries • Valuation and certain tax services are permitted
<ul style="list-style-type: none"> • Fees for providing non-audit services are limited to a maximum of 70% of the average total statutory audit fees paid during the last three consecutive financial years 	<ul style="list-style-type: none"> • Impose stricter regulation • Add further requirements 	<ul style="list-style-type: none"> • No implementation of stricter limits • EU proposals are adopted
<ul style="list-style-type: none"> • Scope of Audit Committees will be increased and role of Committee is strengthened 	<ul style="list-style-type: none"> • Chair of Audit Committee has to be appointed by shareholders annually 	<ul style="list-style-type: none"> • No option is implemented • Both countries follow EU baseline

Appendix 5

Summary of main arguments made in the discourse

Arguments pro mandatory rotation

- Audit quality is improved
 - Fresh-view approach of incoming audit firm leads to more in-depth analysis and more questioning of financial statements
 - Rotation encourages auditors to be more precise as they know that other firm will go through their work again; minimizes the risk of wrongdoing
- Auditor independence and professional scepticism are enhanced
 - Long-term relationships lead to overly close identification of the auditor to the client (familiarity threat)
 - Long-term relationships lead to simple repetition of the procedures every year
 - Long-term relationships lead to an anticipation of a rather than being alert to subtle circumstances
 - Auditor independence in appearance is increased
- Shortcomings of partner rotation are overcome
 - Partner rotation is insufficient, because the incoming partner is under peer pressure within the firm to not lose the client
 - Partner rotation is insufficient, because the incoming partner is not willing to question practices of predecessor openly
- Competition within audit market is stimulated
 - High market concentration is addressed by opening up the market through regular rotation of auditors; enables smaller audit firms to get new clients
 - Ultimately more competition increases quality and lowers cost

Arguments con mandatory rotation

- Audit quality is not improved, but declines
 - Audit quality declines in the first years due to a loss of client-specific knowledge
 - Audit quality declines due to a loss of industry-specific knowledge of audit firms
 - Audit quality declines due to even more pressure on audit fees
 - Audit quality is in the mindset of auditors, additional regulation is not necessary, because audit firms already invest huge sums to improve audit quality
- Cost increase
 - Rotation increases costs for audit firms due to tendering process etc.

- Increase in internal costs for audited entity due to education, knowledge transfer costs in the first years
- Increase in costs for audit firms leads to higher fees
- Effect on auditor independence is irrelevant
 - Familiarity arises between individuals, not firms
 - Partner rotation and existing rules are sufficient safeguards
 - Turnover at client (management, board) even more frequent than auditor change
- Competition within audit market decreases and intensifies
 - Large firms still rely only on Big Four and rotation limits choice between those firms
 - Smaller audit firms lose their rare large clients and will not adequately offset those firms
- Rotation is an artificial intrusion in the market; contradicts idea of free competition
 - Mandatory rotation interferes with regulation on corporate governance
 - Shareholders are not able to decide about the appointment of auditors at any time
 - Knowledge loss in times of financial distress / post-merger times harmful for audited entity / society
 - Multinational firms have difficulties, as requirements are different in each country

Arguments pro rotation / Number of respondent	EU	4	9	11	13	14	25	33	34	37		
Long-term relationships lead to too close identification of auditor with client	x	x					x				3	
Long-term relationships lead to simple repetition of earlier engagement	x						x				2	
Long-term relationships lead to anticipation of problems rather than being alert to subtle circumstances	x						x				2	
Auditor Independence is increased	x	x	x	x			x	x	x		7	
Fresh view might lead to more in-depth analysis	x						x				2	
High market concentration is addressed by opening up the market through regular change	x	x					x				3	
Partner rotation is not sufficient, as incoming partner is under pressure to not lose the client	x						x				2	
Partner rotation is not sufficient, as incoming partner is not willing to question practices of previous one openly	x						x				2	
Enhances audit quality	x			x	x	x					x	5
	9	3	1	2	1	1	8	1	1	1		

Arguments against mandatory rotation / Number of respondent	1	2	5	7	8	9	10	12	15	16	17	18	20	22	23	24	26	27	28	30	31	35	36	38	39		
Audit quality																											
Loss of knowledge leads to lower audit quality in first years	x		x	x	x		x	x	x	x	x	x	x	x	x	x		x	x	x	x	x	x	x	x	x	22
Loss of industry-specific knowledge leads to a lower audit quality			x											x											x		3
Pressure on lower fees increases and leads to lower audit quality													x	x													2
Costs																											0
Increase in costs for audited entity due to education, knowledge transfer costs				x	x		x		x	x						x		x	x	x	x			x			11
Increase in costs for audit firm due to more time commitment			x	x	x				x							x			x								6
Independence																											
Existing rules on internal rotation sufficient as safeguard	x	x	x	x			x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x				x	17
Familiarity can only arise between individuals not firms				x																							1
Turnover at client minimizes familiarity threat									x	x											x	x					4
Audit quality is anchored in the mindset of auditors																x											1
Market intrusion																											
Shareholder /Audit committees shall decide about auditors	x			x			x	x	x	x			x		x					x	x	x			x		12
Rotation regime can be harmful in special times						x			x																		2
Artificial intrusion in market should be avoided, as market knows best																		x			x	x					3
Multinational firms suffer from different rotation periods in different countries					x																	x					2
Not consistent with corporate governance									x								x									x	3
Competition / Corporate Governance																											
Mandatory rotation decreases competition		x		x	x				x	x			x	x				x			x	x			x		11
	1	3	4	6	7	1	2	4	7	7	3	3	4	5	2	7	2	3	4	7	7	2	2	5	2		