Perceptions of the Implicit Changes of Mandatory Audit Firms Rotation: Evidence from Portuguese Audit Firms and Audited Entities

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Biographical Note

Inês Filipa de Almeida Marques was born on 14th July in the city of Coimbra, daughter of António Manuel Teixeira Marques and Ana Maria Bulhões de Almeida.

In 2012, she enrolled the Economics Degree at the School of Economics and Management (FEP.UP), recognizing the quality and the requirements of an area as complex as Economy.

In 2015, after completing the Bachelor Degree, it became evident the need to deepen her knowledge, so she started the Master in Management, also at the FEP.UP.

In 2016, thanks to her master's degree, she did a curricular internship on audit at Deloitte. This experience was very enriching in professional and personal scopes since she acquired more technical skills and knowledge with a more practical perspective.

At the moment, she seeks to reenter into the labor market, in order to be able to develop the skills previously learned and to apply the knowledge acquired over the last years of study.

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Abstract

As a consequence of the new European Legislation on Statutory Audits of Annual Accounts and Consolidated Accounts, materialized by the Directive 2014/56/EU and Regulation Nº 537/2014, the obligation of audit firm rotation is now a reality in the European market. This new legislation aims to reduce market concentration on big four audit firms and consequently enhance auditor's independence by reducing risks associated with high familiarity between the audit organization and the client company. This research aims to contribute to the literature by empirically examining the perceptions of the implicit change and by clarifying this new regulation, its advantages and disadvantages. Thus, the investigation has as base a qualitative approach, resorting to semi-structured interviews and to a sample of Portuguese (big, medium and small) audit firms and audited companies of public interest, aiming to assess the their perceptions concerning to: audit independence, audit quality, audit market concentration and auditor's opinion (the crucial output of the audit work). The results showed that there is not a consensus among the two groups regarding the influence of legislation on the quality and on the issue of an opinion. Moreover, despite there is not also an agreement concerning the perceived impact on the quality in the first year of the audit engagement, all agreed that, in the long run, will exist an improvement. Lastly, all agreed that mandatory audit firm rotation has not influence in the market concentration. These findings reinforce the relevance of the legislation once the majority of audit firms and clients perceived it has being benefic to the audit market.

Key-words: Mandatory Audit Firm Rotation, Audit Quality, Audit Independence, Auditor's opinion

JEL-Codes: M42, M48

Resumo

A obrigação de rotação das sociedades de auditoria é, hoje em dia, uma realidade no mercado europeu, como consequência da nova legislação europeia relativa à revisão legal das contas anuais e consolidadas, materializada pela Diretiva 2014/56/UE e pelo Regulamento (UE) nº537/2014. Esta nova legislação visa reduzir a concentração de mercado nas big four e melhorar a independência do auditor, reduzindo os riscos associados à familiariedade entre a auditora e a empresa auditada. Este estudo contribui para a literatura por examinar empiricamente as percepções das mudanças implícitas do requisito obrigatório de rotação da empresa de auditoria e por clarificar a nova legislação, as suas vantagens e desvantagens Assim, esta investigação tem como base uma abordagem qualitativa, recorrendo a entrevistas semi-estruturadas e a uma amostra de empresas portuguesas de auditoria (grandes, médias e pequenas) e de clientes de interesse público, tendo como objetivo avaliar as suas percepções em relação à: independência do auditor, qualidade de auditoria, concentração do mercado de auditoria e emissão de opinão (*output* crucial do trabalho do auditor). Os resultados mostraram que não existe um consenso entre os grupos em relação à influência da legislação na qualidade e na emissão de opinão. Além disso, apesar de não existir um concordância, entre auditores e clientes, em relação à influência percebida na qualidade de auditoria, ambos concordam, que no longo prazo, vai haver uma melhoria na mesma. Por último, todos concordam que a rotação obrigatória das sociedades de auditoria não tem influência na concentração de mercado. Estes resultados vêm reinforçar a relevância da legislação, uma vez que maioria dos auditores e cliente percepciona que a mesma é benéfica para o mercado de auditoria.

Palavras-chave: Rotação obrigatória das sociedades de auditoria, Qualidade de Auditoria, Independência do Auditor, Opinião do Auditor

Códigos JEL: M42, M48

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1. Introduction

As consequence of impacts of the recent financial crisis and successive frauds not only in the capital market, but also for society as a whole, auditors have been subjected of an increasing pressure (Kogut, J., 2013). Audit profession has been facing a number of issues surrounding the scope of the audit professional's performance and the credibility of the audit profession.

Over the last few years, regulations have been changing in order to adapt to the new economic reality, to strengthen the independence of the auditor and to restore the climate of investor confidence in the profession, causing significant modifications to this area (European Commission, 2014).

Internationally, the appearance of Sarbanes-Oxley Act (SOX) established new mechanisms to a better regulation of the audit market. In the European Union (EU), the work began through the reflections promoted by the *Green Paper*, a publication launched by the European Commission with the goal of reflecting on the role of auditors and their scope of action as a stabilizing element of the financial system (European Commission, 2010). This reflection culminated in the materialization of the new European directive on statutory audits of annual and consolidated accounts and the new regulation on statutory audit of public interest entities, being one of the main alterations, and solution to face auditor's pressure, the mandatory audit firm rotation (MAFR).

The several discussions about auditor rotation are particularly linked to a threat to independence called familiarity. This threat arises from the relationship and trust established between the auditor and the key people of the audited entity and this relationship can be translated into acceptance of explanations of the entity, by the auditor, without proper corroboration of the facts (Barrote, I., 2010). Such relation can reduce their critical spirit to avoid confrontation with the entity with whom they already have a certain relationship. Audit teams are frequently changing due to promotions or staff turnover, however, regarding to the audit partner in charge of the work, the probability of change is reduced. Therefore, taking into consideration the aforementioned information, the most suitable solution to overcome the independence issue is the rotation of auditing companies (Barrote, I., 2010).

According to the survey “Organização e Meios para Prestação de Serviços de Auditoria”, carried out by the Portuguese Securities Market (CMVM), in 2007, only 30% of audit firms had membership rotation policy. The article 42 of Directive 2006/43/EC already stated that the partners responsible for statutory audit functions shall be subject to rotation within a maximum period of seven years from the date of appointment. That directive was amended on 17 June 2016, by the Directive 2014/56/EU of the European Parliament and of the Council on statutory audits of annual accounts and consolidated accounts. Furthermore, the EU Regulation Nº537/2014 also came into force, and both have imposed a new legal regime for audit firm rotation.

In this new legal context, public interest entities are obliged to change their statutory auditors, or their audit firms, every ten years. The duration of the audit engagement has to be calculated since the date of the first financial year covered in the audit engagement letter. However, member states might extend the maximum duration of an audit work by an additional ten years upon tender, or fourteen in the case of joint audit (EU Regulation Nº537/2014, article 17).

Several authors have studied the impact of auditor rotation and the existence of a real benefit associated to its adoption. There is few evidence on the effects of audit firm rotation and no consensus concerning the benefits of audit alternation. Moreover, there is also limited empirical evidence about the relationship between audit-firm tenure and financial reports quality. Therefore, there is not clear if MAFR is solving a real problem.

This dissertation aims to contribute to the present literature by providing an empirical study about the perceptions on the impacts of MAFR at the eyes of two relevant stakeholders: audit firms and audited companies.

Interviews with audit companies and audit clients were conducted to obtain evidence about the perceptions of the impacts, advantages and disadvantages of MAFR.

The main research questions of the present dissertation are the following:

1 – How is the new legislation different than the previous one?

2 – What are the perceived consequences, advantages and disadvantages of MAFR as seen by auditor firms and their clients?

3- What, if any, is the expected influence of the new legislation on the auditor's opinion?

This dissertation is structured as follows: chapter 2 presents a literature review about auditing, while chapter 3 provides a description of relevant legislation in Portugal. Chapter 4 discloses the methodology adopted in the study. And, chapter 5, presents the main results and discussion.

2. Literature Review

This chapter focuses on the main concepts and theories relevant for the audit research field. Firstly, a definition of audit and its related concepts (audit quality, auditor's independence, MAFR, among others) is presented. Secondly, a literature review is provided covering different theories and frameworks that have been developed based on the changes and the progress of auditing. Thirdly, similar studies and their contribution to the audit field will be presented. Lastly, a critical analysis of the literature reviewed will be provided.

2.1. Audit

Audit has a Latin origin, that comes from *"audire"* (hear), and was adopted by the English as auditing, to describe the accounting review (Cunha and Pinheiro, 2003). In order to adapt to new economic reality, the concept of audit has been extended through time. If initially aimed at the discovery of errors and fraud, audit practices went after extending up to other areas and to take specific or specialized forms. Therefore, the historical developments allow us to check how audit was a reflection of the economic and social changes that have been operating since been established as branch of knowledge until the present (Tribunal de Contas, 1999).

In 1998, the author Attie defined audit as a dedicated accounting expertise to test the efficiency and effectiveness of asset control deployed for the purpose of expressing an opinion on certain data. Sá (1998) defined it as accounting technology applied to the systematic exam of the registers, financial statements or other reports, having as goal to present opinions, considerations, conclusions, criticism and guidance.

Recently, the International Auditing and Assurance Standards Boards (IAASB, 2014) affirms that auditors play a key role in contributing to the credibility of the financial statements on which they are reporting. Thus, citing the International Standard on Audit (ISA 200), the purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. Citing also Deloitte (2016), one of the big four, auditing is a highly complex process, and the importance of auditors as a vital link in the financial reporting chain has never been more important nor their role as trusted advisors more value.

Audit concept can be easier to understand through its overall objectives:

> *"(...) (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and*
> *(b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings. (...)" (ISA 200, 11)*

Audit term is not static and has been discussed during the last few years due to the disloyalty in the audit market provoked by financial crisis and scandals.

2.1.1. Audit Quality

Audit quality is a key concept in this field of research. However, there is no globally accepted definition of audit quality (Public Company Accounting Oversight Board, 2013). DeAngelo (1981) defined it as:

> *"(...) the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach."*

Attending to this description, the quality of audit is ensured through auditors' capacity to discover the breach and their objectivity and independence to report a breach or misstatement in the accounting system or financial statements. However, despite being broadly quoted, this definition is also criticized for being vague and imprecise (Kilgore, 2007)(*Apud* Raslan *et al.*, 2016).

According to Monroe and Tan (1997),

> *"(...) the quality of an audit can affect the reliability of audited financial information, which in turn plays an important role in capital markets."*

Therefore, audit quality is fundamental to enhance the reliability of the financial statements and to provide security and confidence to the capital market participants.

The Public Company Accounting Oversight Board (PCAOB, 2013), described audit quality as:

> *"(…) meeting investors' needs for independent and reliable audits and robust audit committee communications on: financial statements, including related disclosures; assurance about internal control; and going concern warnings."*

This definition is more focused on results rather than the process itself or inputs. PCAOB affirms that is easier to define audit quality in terms of results.

As already mentioned, there is no agreement regarding the definition of audit quality. While some authors define it as the auditors' ability to perform its work in accordance to standards and professional requirements, other focus more on error detection and financial statement outcomes. According to Raslan *et al.*, 2016, the definition might differ according on the perception of quality for the parts. As a consequence of the recent financial crisis and corporate collapses, perception of audit quality have been discussed over the last years, having resulted in changes in regulation (Harrison *et al*., 2011).

To conclude, Raslan *et al.* (2016) proposed their definition for audit quality, agglomerating other authors' ideas:

> *"(…) the one performed in accordance with legal and professional requirements in a manner that could improve the reliability of financial reporting taking into consideration the interests of different parties concerned with such quality".*

Hereupon, it's also important to mention and clarify some examples of lack of quality that can be reflected in the financial statements.

One way to measure the quality of the audit service is related to auditor's capability to prevent earnings management (Martinez, A. and A. Moraes, 2017). Earning management is the act of, intentionally, taking advantage of how accounting rules are applied and influence the process of create the financial statements to obtain private gain. Thus, there are several studies concerning the relation between audit and earnings management, being expectable that audit work be a restriction to managerial discretion in reporting earnings, helping to improve the reliability and the quality of the financial information (Huguet, D. and Gandía, J., 2016).

Moreover, it's also important to understand the relation between earnings management, audit quality and voluntary/mandatory audits. Minnis (2011) and Dedman, E. and A.

Kausar (2012) studied the effect of voluntary audit on accounting quality (not considering the variable mandatory audits) concluding that audit improves quality. However, it's also important to have in consideration the scenario of mandatory audit once that financial information is influenced by whether audits are voluntary or mandatory. Thus, the work of Huguet, D. and J. Gandía (2016) was based in the three variables (audit quality, voluntary audits and mandatory audits) and concluded that despite the fact of voluntary audits constrains earnings management, the effect is more visible when the audit is mandatory. Thus, although both mandatory and voluntary audits reinforce audit quality by restricting the magnitude of accruals, the lower visibility and litigation risks faced in the voluntary case incentive them to be less restrictive.

Other interesting topic is the relation between audit quality, earnings management and audit fees. Audit firms tend to compete to offer a personalized service that add value to the client, charging higher fees for better quality services (Francis, J., 1984). Thus, audit fees can also be a metric of audit quality (Hallak, R. T. P. and A. L. Da Silva, 2012). However, higher fees does not necessary means more objectivity and independence from the auditor. Once again, there is not in the literature review an agreement between the authors. While some defend that higher fees imply a more competent service and lower fees means poor quality, other studies concluded that higher fees can have as a consequence the loose of independence (Eshleman, D. and P. Guo, 2014). Kinney, W. R. and R. Libby (2002) found that higher audit fees could mean illicit acts by the company and inflated future earnings. The work of Martinez, A. and A. Moraes (2017) studied the relation between audit fees and audit quality, using as proxy the earnings management, and concluded that abnormal audit fees create a setting that is more propitious for earnings management.

Another example of lack of quality is the discretionary accruals. Discretionary accruals is an expense that is not mandatory, which has not yet been performed, but is recorded in the company's account books, such for example management bonus. The study of Huguet, D. and J. Gandía (2016) found that non-audit companies have a higher level of absolute discretionary accruals than the audited companies. Also, Myers *et al.* (2003) examined the relation between audit quality, using discretionary accruals and the current accruals as proxy, and audit tenure. They found that a long audit tenure implies more constraints on both income increasing and income decreasing accruals. Thus, audit quality impairs with audit tenure.

The work of Becker *et al.* (1998) is also relevant for this point. Their study examines the relation between audit quality and earnings management, being this last variable captured through discretionary accruals. Assuming that auditors from *big six* are of higher quality comparing with non-big six audit firms, they concluded that clients from non-big six are more properly to report discretionary accruals than clients of *big six*. Also, the mean and median of the absolute value of discretionary accruals is higher for non-big six clients.

To conclude this topic, both earning management and discretionary accruals are example of lack of quality and that can be pointed out as one of the reasons that lead to MAFR.

2.1.2. Audit Independence

Audit independence has been in focus during the last years, being object of study by several authors (Almeida, 2015). The independence requirement is due to the pursuit of two basic goals. Audit work be performed with high quality, without the influence of external factors, affecting the auditor's opinion. And also, to provide confidence in financial statements to investors (Figueiredo, 2011).

According to Knapp (1985) (*Apud* Figueiredo, 2011), independence consists in the ability to resist to the pressure exerted by the clients, and based on Arens *et al.* (1999) (*Apud* Figueiredo, 2011), this concept refers to taking an unbiased position when conducting audit tests, results evaluation and issuing an audit opinion, and has underlying the integrity, objectivity and impartiality of the professional. For Schandl (1978) (*Apud* Figueiredo, 2011), independence consists in ensuring that personal and material interests, as well as the emotions of any professional auditor remain intact, and are not affected by third parties, for expressing their opinion and conclusions.

Moreover, according with Shockley's work (1981), auditor's credibility depends ultimately on the society perception rather than on the fact of independence. The study concluded that companies inserted in highly competitive environments and smaller audit firms were perceived as having a higher probability of loss of independence. However, the audit tenure seemed to don't have a significant impact on perceptions of independence. Also the work of Geiger and Raghunandan (2002) and Myers *et al.* (2003)

concluded that longer audit tenure, rather than shorter audit tenure, is associated with higher quality earnings.

Therefore, independence is a dynamic concept, being influenced by different types of variables. These meaning and importance have been adapting to the new economic realities (Almeida, 2014) and depends on the critical sensibility of the various authors (Figueiredo, 2011).

2.1.2.1. Non-Audit Services and Independence

Another interesting topic is related to the relation between non-audit services and auditor's independence. The auditor must have an ethic, independent and objective conduct. When performing his work, the auditor has access to confidential information, once that it has not yet reported to the market. Thus, it might take the auditor to develop a threat of personal interest, leading him to get a counterpart for himself.

In the United Stated of America (USA), the Sarbanes-Oxley Act (SOX), since 2002, prohibits auditors from providing certain types of non-audit services to their clients. Moreover, the Securities and Exchange Commissions (SEC) has also revised the norms concerning to auditor independence, being that the rules now limit the circumstances and remuneration associated to providing certain types of non-audit services. According to Gul *et al.* (2007), both regulations seems to be based on the assumption that certain types of non-audit services provided by audit firms are likely to jeopardize auditor independence, and ultimately reducing audit quality.

In Portugal, according to the Statute of the Order of Chartered Accountants (Law Nº140/2015, articles 70º, 71º, 77º, 78º and 79º), the auditor or audit firm that provide a service to a public interest entity is prohibited to provide, directly or indirectly, to the audited entity, to its mother enterprise or to the entities over its control in the European Union the following types of non-audit services (article 77º, number 8):

- Preparation of accounting records and financial statements;
- Evaluation services;
- Tax consultancy services and preparation of tax returns, conducting a fiscal planning policy, or provide support to solve conflicts from this nature;
- Internal audit services;

- Information technology services;
- Support services in the settlement of various disputes;
- Recruitment and selection services;
- Business finance consulting services.

Several authors have studied the relation between non-audit fees paid to audit firms and auditor independence. According to Frankel *et al.* (2002), there is a positive relation between non-audit fees and the magnitude of discretionary accruals (used as a proxy of earnings management), supporting that high non-audit fees are likely to impair auditor independence. However, Ashbaugh *et al.* (2003) used a more consistent measure of discretionary accruals and did not find a significant relation between the two variables. Also the work of Chung and Kallapur (2003) used a different metric and did not find a statistically association.

Gul *et al.* (2007) also considered auditor tenure besides variables non-audit fees and auditor independence in order to evaluate if the last variable influences the relation between the other two. Their study concluded that non-audit fees are likely to influence auditor independence for firms having short auditor tenure, and when the client firm size is small.

2.2. Mandatory Audit Firm Rotation

According to Cardozo (1997), our society is currently dominated by big organizations having impact in almost all the life's aspects. Due to its great influence and given the existence of information asymmetries and the potential for conflict interests, between company management and outside users of financial information, financial reports should be audited by a third party (Watts and Zimmerman, 1986). It's imperative to ensure the audit work is properly done in accordance with audit quality standards and with the audit independence requirements.

Hereupon, the concept of MAFR is not a recent one. Contrariwise, since 1970, it has been a discussed topic by legislators and regulators. The controversy arises from the fact of an audit firm be paid by the client to issue an audit report on its financial statements, but also is expectable to be independent and objective (Edwards, 2014).

Auditors has to be able to express an opinion regarding to the financial reports, which are one of the main means of communicating financial information to those outside the company.

According to PCAOB (2011), who are in favor of MAFR consider that potential pressure over auditors by management would be substituted by an improvement of audit quality, due to the fact of audit work can be targeted to scrutiny by another audit entity.

The argument is based on the fact that long auditor tenure may lead to a reduction on audit quality. If an audit firm maintain providing audit services for the same entity for a long period, the risk of developing a close relationship with the client might influence and compromise independence. Some clients are seen as having a strong financial position and with a competent management. In the other side, auditors may expect these client's behavior in the future which may reduce the skepticism and objectivity of their work. Periodically changing the audit firm allows to have a new opinion on financial statements, allowing auditors face appropriately with the issues that might came up (Carey and Simnett, 2006). Also, a long relationship with the same client can be seen as a source of a perpetual annuity. Citing the Commission on Public Trust and Private Enterprises (CPTPE) (2003):

> *"Rotation of auditors would also reduce any financial incentives for external auditors to compromise their judgment on borderline accounting issues. In disagreeing with management, auditors would no longer be risking a stream of revenues that they believed would continue in "perpetuity", since the audit engagement would no longer be perceived as permanent".*

Once auditors' independence are under threat, fraudulent financial reporting is more likely to occur. Authors who are in favor of MAFR expect fraudulent financial reporting to be lower in the early years of the audit-client relation and higher in a long audit-firm tenure situation.

On the other hand, the opponents of MAFR, as Myers *et al.* (2004), Cameran *et al.* (2012) and Ghosh and Moon (2005), claim that the obligation of changing auditor will result in higher costs. They also points out that audit quality will decrease during the first years with the new engagement, as the auditor moves through the learning curve. Another disadvantage mentioned is the fact of this regulation not consider that only exist a certain number of qualified successors, since some auditors have more knowledge in certain industries and sectors.

Auditor's knowledge is a crucial input to detect material misstatements. However, although auditors use different types of knowledge (industry and general knowledge), the most relevant one is the client-specific (Melo, A., 2014). According to BDO Seidman (2003), the auditor has to be familiar with the client's environment (business, operations, accounting policies and controls).

Thus, on one side, some authors are focused on auditor knowledge, arguing that audit quality is lowest in the early years of the auditor-client relationship and that quality is higher given longer tenure. In the opposite, certain studies are more concerned with auditor independence threats. Audit quality will be compromised in long auditor tenure and that audit quality may be higher in the early years of the relationship.

However, PCAOB (2011) does conclude on the potential benefits/cost of MAFR, concretely, to which point of view has a higher impact to organizations.

According to Simnett *et al.* (2014), there are several studies concerning to this topic. The works of Deis and Giroux (1992), Bazerman *et al.* (2002) and Davis *et al.* (2009) concluded that audit quality decreases as the length of audit tenure increases. But Geiger and Raghunandan (2002), Johnson *et al.* (2002), Carcello and Nagy (2004) and Myers *et al.* (2004) provided controversial results. Myers *et al.* (2003) and Ghosh and Moon (2005) found results against the rationale of the MAFR.

Despite the number of studies regarding this topic there is not yet a consensus about the potential benefits/cost of MAFR.

The next table, Table 1, summarizes the arguments in favor and against the MAFR:

Arguments in favor of MAFR	Arguments against MAFR
Risk of developing a too close relationship with the client, compromising the independence;	The new audit team might miss problems from the previous periods due to its lack of experience with the client;

Periodically having a new auditor would bring a fresh look to the organization's reports and help auditors to properly deal with financial reporting issues since auditor's tenure will be shorter;	There are not enough large audit firms to address the audit requirements of large companies, causing auditor rotation impracticable at the ground level;
Reduce the concentration of audit market in the big four.	The rotation would only prevent auditors of having a more deeply knowledge of a client and its business.

Table 1: Arguments in favor and against MAFR (own elaboration)

2.2.1. Impact of MAFR in Auditor's Independence

Auditor's independence, as already mentioned, is one of the main reasons why the MAFR was established.

The argument is that audit work will be conducted in a more unbiased and objective way in a MAFR scenario, without being influenced by an eventual pressure of a long date relation (Cameran *et al.*, 2005). The MAFR assumes that even rotation of only the partner responsible by the audit work might not be enough to ensure independence once that audit team, who develops the substantial audit work, is not covered by this mechanism. The obligation of rotation of the partner has essentially impact in summing up the main conclusion and in issuing an opinion.

The MAFR will ensure a new audit team, a new fresh look over the financial statements and, as a consequence, supposed greater independence. However, it is crucial to take a look to the "whole picture" and impacts to understand the costs of implementing MAFR.

2.2.2. Impact of MAFR in Audit Quality

Audit firm rotation will bring a new fresh look concerning to the financial information once that the audit team will perform more substantial work instead of using assumptions from the previous audits (Melo, A., 2014). However, is this "fresh new look" enough to increase audit quality once that exists a rupture created at knowledge level?

The quality of the auditor's work is a crucial element, being the auditor profession so rigorous and regulated. Auditors have to perform substantial work to be able to give an opinion concerning the financial statements. Therefore, it is necessary that auditors know deeply the organization being audited and all the requirements concerning its activity.

An academic work from SDA Bocconi School of Management (2002), showed that the number of sanctions to auditors, concerning to quality control, are higher in the first years of the engagement, proving that exists a decrease of audit quality during that period.

Thus, there are several authors that consider that quality work are jeopardize during the first years of the auditor-client relationship, and then, with the increase of auditor's knowledge on organization activity, there is an increase in quality once auditors are more likely to find material misstatements.

2.2.3. Impact of MAFR in Audit Market Concentration

MAFR imposed a reconfiguration from the players of the audit market. It is expected to observe a change in the market share of big four.

Before the new regulation, the register of auditors at CMVM was a complex and rigorous process, and was hard to create relationships with public interest entities (PIE) in order to perform audit services. Henceforth, with the new regulation, the register in CMVM is simplified, depending only from auditors' will to have access to PIE.

In accordance with the new wording of the article 8, Nº1, of the Portuguese Securities Code, the functions of the "auditor registered at CMVM" are now performed by statutory auditors, which, under the general terms, must be registered at CMVM for the exercise of functions in PIE.

As Deloitte (2012) mentioned, MAFR decreases the audit market concentration, in particular in the entities with some size and complexity operating on industries requiring specialization, alerting for the companies difficulties in being specialized in certain activities sector.

2.2.4. Benefits vs Costs

One relevant topic regarding this domain is to assess if the benefits associated to MAFR are higher that their implicit costs, authors are not yet in agreement regarding to this aspect.

Previously mentioned, the first years of a new engagement might represent a higher risk to the auditors once that is necessary to achieve a sufficient level of knowledge to be able to issue an opinion. Thus, depending on the audited society, it is necessary to affect more resources in the first years of the engagement.

The price is also a fundamental element in the equation. Both sides, the audit firm and the audited organization, desire the minimal price to ensure that the work is provided in accordance with the requirements, without problems. MAFR is bringing an addition to this cost for the audited companies (Ghosh and Moon, 2005).

2.2.5. The Italian example

Italy can be considered as a developed country with regard to the adoption of MAFR, having been one of the first European countries to implement it in 1975 (Melo, A., 2014).

The rule was enforced by Presidential Decree D.P.R. 136/1975, becoming effective for all listed companies in the mid-eighties. Regulation imposed a maximum term of three years by mandate, renewable two times, totalizing a maximum period of nine years. Despite the several critics, MAFR remains consistent with its early form.

Thus, once MAFR has been applied for some years, Italy is an important contribute to understand and to perceive the effects of this rule in Portugal. However, once again, the opinions concerning the impact of MAFR to Italy diverge.

Cameran *et al.* (2012) are against saying that rotation implies an addition to costs, which is only compensatory if it directly influences the quality of the audit work. However, the same doesn't happen. As already mentioned, the quality is really influenced by auditor knowledge concerning the audited company. As the learning curve proves, knowledge increases as the auditor gains experience with the client. Another important aspect considered in their study was market concentration. Contrary to what was expected, the market share of big four had an increase.

In response to some constrains, Italian govern created a study commission with the goal of analyzing the transparency in force in the listed entities market, being one of the main aspects related to the efficiency of MAFR. This study concluded that MAFR was an important drive of transparency and objectivity, once auditors are not influenced by hope of renewal (FEE, 2004).

Hereupon, the Italian example allowed us to perceive that despite of not existing a consensus regarding to MAFR, in this specific case, there is a higher number of negative impacts of this mechanisms, studied and analyzed by diverse authors, alerting for the hypothesis that maybe MAFR is not the best measure for the European market to reinforce auditor's independence and the quality of audit work.

2.3. Main Theories and/or Models

Several different theories have been used to clarify the need and demand for audit. Four of those main theories will be mentioned and explained in the following paragraphs.

Until 1940, the Policeman Theory was broadly acceptable in audit. According to this theory, the auditor should behave as a policeman focusing on arithmetical accuracy and on the prevention and detection of fraud. However, as already mentioned, the main goal of audit is to provide reasonable assurance and verify the truth and fairness of the financial statements. Beyond that, the detection of fraud is a conflictual topic that is still in debate on the auditor's responsibilities (Ittonen, 2010). In this sense, given the contradictions explained, there is a loss of importance of this theory.

The Lending Credibility Theory affirms that the primary function of audit is to enhance the credibility of the financial statements. In accordance with this theory, auditors are providing, or even selling, credibility. Financial statements, when audited, are used to add confidence to the management (Ittonen, 2010). In audit terms, audit will reduce the information asymmetry, allowing the users of financial statements to make better investment decisions, sustained by trustful information. However, some authors, as Porter (1993), affirmed that audited information should not be a primary basis when doing an investment decision.

The Theory of Inspired Confidence (of Limperg) addresses both the demand and the supply for audit services. The participation of outside stakeholders in an organization has as consequence a demand for audit services. Stakeholders require accountability from management in exchange for their participation to the company. Knowing by hand that management can be tempted to provide biased information, audit services are required to assess it (Ittonen, 2010). Regarding the supply of audit services, the auditor's function is strive to meet the public expectations and to provide a certain level of assurance to stakeholders. In short, this theory connects the society's need for reliability of financial information to the ability of audit procedures to meet these needs (Sijpesteijn, 2011).

Lastly, Agency Theory (Watts and Zimmerman, 1978) addresses the relationship between managers and investors. The manager has to perform its duties according to the interest of investors (Jensen and Meckling, 1976). Therefore, the role of the auditor is to supervise the relationship between these two agents. However, the responsibility of each part has to be well defined in order to avoid gap expectations. Thus, organizations hire auditors to review managers' work and to reduce record errors, asset misappropriations or even fraud within the company. Thereby, through the requirement of audit services it is expectable to observe a decrease of potential interest' conflicts, and in parallel an increase in investor's wealth and in company's value (Inácio *et al.*, 2015).

The new directive can be explained having as base the Lending Credibility theory. The MAFR aims to reduce the threat to audit independence, resulting from a close relationship developed between the audit firms and the clients, and to increase the audit quality, performing more substantive tests. Once these goal are ensured, the credibility of financial statements will increase and the information asymmetry will be reduced, since auditors will have an external pressure to perform a more carefully and rigorous work.

2.4. Similar (relevant) studies

There are several studies that analyze the impact of firm rotation on audit quality, on audit independence and on auditor's report.

Melo (2014), analyzed the relation between listed firms audit rotation and auditor's opinion. Using a sample of listed Portuguese firms, from 2000 to 2013, the author aimed to understand the existence of additional qualifications as a consequence of audit rotation. The main conclusion was that MAFR leads to a reinforcement of auditor's independence and to a higher degree of opinion's qualification.

Simnett *et al.* (2014) used a sample of 6,710 companies listed on the Korean Stock Exchange, from 2000 to 2009, and concluded that audit quality did not increase significantly, when compared with a period before the implementation of MAFR. The authors also concluded that audit fees are considerably higher than in the pre-regulation period.

Fontaine *et al.* (2015) studied auditor independence, objectivity and the costs associated with switching between audit firms. The authors interviewed 19 audit committee members' interviewed and all of them did not defend the adoption of MAFR. In their opinion, professional judgment and observations are the most effective tool to ensure auditor independence.

Cameran *et al.* (2016) analyzed changes in audit quality during the auditor engagement period. Using a sample of Italian non-financial listed companies, from 1985 to 2004, this study proved that not only auditors become more conservative (preferring more conservative accounting) in the last year, compared with the previous, but also the investors tend to perceive a better audit quality in the last year.

In conclusion, despite the considerable number of studies on the impacts of audit firm there is not yet a consensus. While some authors are in favor of the obligation of audit firm rotation and defend that it will bring benefits for the audit sector (Bazerman *et al.*, 2002, Davis *et al.*, 2009, among others), other authors defend that benefits are not as clear as they seem to be and that the inherent cost of this directive can be higher than the expected (Myers *et al.*, 2003, Ghosh and Moon, 2005, among others). Besides that, in the literature review, there is a lack of research concerning this topic in a Portuguese context.

This investigation intends to fulfill a gap in the literature, by providing evidence of the perception of Portuguese audit firms (of different sizes) and audited entities on the impacts of the MAFR namely on audit quality, audit independence, audit market concentration and on the auditors' opinion.

3. Legislation in Portugal

Presently, the audit market is regulated by the Directive 2014/56/EU, of 16th April of 2014, of the European Parliament and by the Council on statutory audits of annual accounts and consolidated accounts. The EU Regulation Nº537/2014, of 16th April of 2014, also was adopted, and both have imposed a new legal regime for audit firm rotation. Moreover, in Portugal, two national measures have resulted from this: Law nº140/2015 (regarding the new Statutes of the Order of Chartered Accountants), of 7th September, and Law nº148/2015 (concerning to the legal regime of audit supervision), of 9th September.

The Law Nº140/2015 establishes the legal regime for creation, organization and operations of professional public associations. While the Law Nº148/2015, which amends the Directive 2006/43/CE, ensures the execution, in the intern legal order, of EU Regulation Nº537/2014, is relative the specific requirements for the legal account revision of public interest entities.

One of the main changes of this new legal context, from the previous directive, is related to its structure. New directive completely separates the regulation of the audit activity of the so-called “normal” entities of public interest entities, the latter being contemplated on EU Regulation Nº537/2014.

This new European directive aims to establish the goals of audit profession of the members’ states with the view of European harmonization. Each state member opts for the ways to achieve that goals, being all obligated to adapt it and to transpose it into national law.

The new directive introduces news that respects to: some definitions, including the public interest entity definition, the rules concerning the independence and objectivity of the auditor, the general organization of auditor and his work, the quality control and new requirements regarding to penalties and sanction, the audit report and to the additional requirements for the audit committees of public interest entities.

One innovation that should be highlighted regarding this topic is the possibility of providing audit services by an entity from a member state in another member state of the EU. Following the philosophy of common market of EU, sustained by the free circulation of goods, services, people and capital, this opening will foster the growth of audit firms, allowing the various organizations of small and medium size to develop, being also an instrument to decrease the audit market concentration in the big four.

It also should be pointed out the temporary impediment to hire the statutory auditors by the audited companies to carry out management duties, functions in the audit committee and supervision bodies. This measure presupposes a minimum period of one year, or two in case of public interest entity, before a possible hiring.

Lastly, the highlight goes to the article Nº25A, mentioning that the scope of statutory audit "not include a guarantee regarding to the future viability of the audited entity or the efficiency and effectiveness with which the management or management body has conducted or will conduct the entity's activities" (European Commission, 2014). This statement is a legislative safeguard and clarifies the scope of audit profession to all users of financial information.

3.1. Public Interest Entity definition

As mentioned above, the definition of public interest entity changed with new regulation. Once MAFR is applied to these entities, it's important to recognize the companies under this rule. Thus, the companies are considered as PIE, according with Law nº148/2015 of 9th September, article Nº3, when they are:

- The issuers of securities admitted to trading on a regulated market;
- Credit institutions;
- Investment firms;
- Collective investment undertakings;
- Venture capital companies, venture capital investment companies and venture capital funds;
- Specialized alternative investment companies and specialized alternative investment funds;
- Credit securitization companies and securitization funds;
- Insurance and reinsurance undertakings;
- Holding companies, when the holdings held give them the majority of voting rights in credit institutions;

- Holding companies in insurance sector and the mixed insurance holding companies;
- Pension funds; and,
- Public undertaking which, for two consecutive years, have a turnover in excess of EUR 50 million or a net asset in excess of EUR 300 million (do not mention when they start counting the two years).

3.2. Mandatory Audit Firm Rotation in Portugal

The focus in this dissertation is the MAFR stated in the EU Regulation Nº537/2014, article 16 and 17, and is synthesized in two parts, the designation and the duration.

The auditor nomination should occur by recommendation of the audit committee to the audit entity, in which in an exempt form presents, at least, two options, and affirms his independence regarding to the choices. If designation corresponds to a possible situation of renewal of mandate, it is elaborated a selection process, with previous requirements defined by the committee, being then elaborated a conclusion report of the process explaining the results, having as base the criteria defined.

Regarding the duration, public interest entities are obliged to change their statutory auditors, or their audit firms, every ten years. The time of the audit engagement has to be calculated since the date of the first financial year covered in the audit engagement letter. However, member states might extend the maximum duration of an audit work by an additional ten years upon tender in the case of designation is made through public tender, or fourteen in the case of joint audit. The extension only becomes effective by recommendation of audit committee, headed to the general meeting of shareholders. To this exclusive extension, there is yet the possibility, exceptionally, of public interest entity require to national authorities the extension of the auditor mandate, with a maximum duration of two years.

Concerning the rotation of the responsible partners of the audit work, the duration is the same of the previous directive, which is seven years, being the only difference the time before new designation, from two to three years. The new directive allows the state members the possibility to reduce the maximum period of seven years.

The auditor or audit firm should also create internal mechanisms of internal rotation, including, at least, people recognized as statutory auditors. Also, the auditors have to be able to demonstrate that the same is being applied and is in accordance to the context and the activity. Therefore, the rule ensures not only rotation of the partners responsible by the work but also the rotation of audit team.

The rotation of partners and of audit firms comes in response to reinforce auditor independence, by reducing the threat of familiarity, but will also change the audit market structure and the quality of audit work.

4. Methodology

The present investigation has as goal to understand the perceived impact of new audit legislation, mainly on audit quality, audit independence, audit market concentration and auditor's opinion, by the auditors and the audited entities. It is important to take into account that the issue in question is characterized by scarcity and dispersion of data, since the adoption of legislation is recent and few authors have considered it. Moreover, as already mentioned in the literature review, there is a lack of studies regarding the obligation of audit firm rotation having as evidence entities from Portugal and there is not a consensus concerning the main impact of it.

Considering the similar studies considered in the chapter 2, visible in table 2, one can conclude that there is not a defined pattern regarding the methodology used for the analysis of the MAFR.

Similar Studies	**Methodology/Sample**	**Country of Study**	**Conclusions**
A Rotação das Sociedades de Auditoria: Estudo dos Pareceres do PSI Geral (Melo, 2014)	Quantitative and Case Study Sample of listed companies, from 2000 to 2013	Portugal	MAFR leads to a reinforcement of auditor's independence and to a higher degree of opinion's qualification.
The effect of MAFR on Audit Quality and Audit Fees: Evidence from the Korean Market (Simnett *et al.*, 2014)	Quantitative Sample of 6,710 listed companies, from 2000 to 2009	Korean	Audit quality did not increase significantly and audit fees are considerably larger than in the pre-regulation period.

Audit committee perspectives on mandatory audit firm rotation: evidence from Canada (Fontaine *et al.*, 2015)	Qualitative Interviews to 19 audit committee members	Canada	The interviewed members don't defend MAFR. Participants believe that their professional judgment and observations are the most effective way of ensuring auditor independence and view MAFR as an unnecessary intervention.
MAFR and Audit Quality (Cameran *et al.*, 2016)	Quantitative. Sample of non-financial listed companies, from 1985 to 2004	Italia	Auditors become more conservative and investors tend to perceive a better audit quality in the last year.

Table 2: Methodological aspects of the similar studies (own elaboration)

The empirical analysis to be undertaken in the present study aims to assess the differences that new legislation will imply, if any, and the advantages and disadvantages from it, and if really exists an influence of MAFR on the auditor's opinion.

For this dissertation, due to the characteristics of the information available and to the fact that legislation was adopted recently, our analysis will be mainly focused on a qualitative approach. This methodology will use data from interviews and legislation analysis.

According to Mason J. (2002), the qualitative analysis is recognized as important once it allows to explore several dimensions from the social world, such as the understanding and experience from the participants. This way it's possible to perceive problems, study behaviors or attitudes, allowing to develop concepts and ideas through patterns discovered in data and not only collect data to check models, as in a quantitative analyze (Sousa, M. J. and C .S. Batista, 2011). With a small data, it's possible to obtain rich, detailed and new information. In line with the presented above, this study will opt for the use of in-depth interviews, which are characterized in a qualitative investigation by the existence of open questions and a small sample. Thus, it will be explored, through the usage of interviews, the knowledge, perception and experience of people that assume a crucial role from the social reality at the qualitative methodology (Mason J., 2002). According to the same author, the interviews have implicit a more complex and exhaustive planning and implementation than questionnaires, where the questions and answers are previously defined. Regarding the structure, it will be semi-structured in order to facilitate the comparison and analysis of the data. This type of interviews are presented as a dialog-based interaction, with a relatively informal style, focused on topics and on the relevant contexts so that knowledge can be produced (Mason J., 2002).

Therefore, through the interviews this investigation aims to understand the perception of the people interviewed concerning the MAFR. Thus, it’s crucial know how to manage the social and intellectual dynamics of the interview in order to obtain relevant data, since they depend on the people’s ability to verbalize, remember and interact (Mason J., 2002).

Concerning to the interviews to audit firms, the main aim is to understand their opinion concerning this new legislation and what are, if any, the main changes that it will imply inside the company (in terms of costs and non-audit services). These interviews will also allow to know if the perception is influenced by the size of the audit firm. Moreover, it aims to realize if the auditors are more rigorous and weighted, when performing their job with a new client, and if it exists any influence of MAFR on the auditor’s opinion.

Regarding the interviews to the audited entities, the main goal is to understand what is their perception regarding the impact of a new team on the quality and on the issue of an opinion.

4.1. Methodology

An exploratory qualitative methodology was adopted for the present research.

Data collection was done through the use of semi-structured interviews. When using semi-structured interviews a prior set of questions / topics are identified, the script, although the interviewee has some freedom to approach related topics (Sousa, M. J. and C. S. Baptista, 2011). According to Manzini, E. J. (2004), one of the characteristics of this type of interviews is that the interviewer don’t have to become a hostage of the questions prepared in advance. Semi-structured interviews allow to ask other type of questions, not included in the script, to understand better the information that is being provided or even the chance to ask momentary questions that seem to have relevance for the topic.

This methodology was deemed the most adequate given the importance of both 1) collecting perceptions of specific aspects of the MAFR (such as audit independence, quality, opinion and market concentration) and of 2) allowing a certain degree of freedom of expression to capture opinions not previously considered in the interview scrip, thus enriching the work through the depth and diversity of information,

The interview script was designed (see Annex 1 and 2) and was based on previous research of several authors (Johnson, V. E. *et al.*, 2002; Jackson, A. B. *et al.*, 2008; and, Melo, A., 2014, among others) and on the extant literature review.

The sample was defined according to the following criteria:

- For auditing companies: a selection of big, medium and small audit companies. Big companies were chosen between the big four audit companies; medium companies were considered as companies that provide more than audit services and have three or more auditors; and, small companies only provide audit service and have only one or two auditors;
- Concerning the audited entities: only public interest entities were considered.

Interviewees were scheduled through emails, in some cases directly to the interviewees, and in others, in a first instance to the firms' general e-mail which was then re-routed to the individuals that matched the desired criteria. It was possible to perform a set of 9 interviews, 6 to male and 3 female participants. Being interviewed 2 partners of big audit firms, 2 partners of medium audit firms and 3 of small audit firms. Concerning the public interest entities, 2 public interest entities were interviewed. To protect the confidentiality of the interviewees, their names have been replaced by initials according to categories. Auditors have been replaced by BAF (big audit firm), MAF (medium audit firm) and SAF (small audit firm) and clients by CF (client firm). Table 3 provides the characterization of the sample:

Interviewed	Age	Gender	Academic Qualifications	Years as Statutory Auditor/ Working in the Client	Job
SAF1	59	M	Master in Business Finance	18	Partner Auditor
SAF2	40	M	Bachelor Degree in Management and in Law	11	Partner Auditor
SAF3	60	M	Bachelor Degree	22	Partner Auditor
MAF1	41	F	Bachelor Degree	6	Partner Auditor
MAF2	46	F	Bachelor Degree	16	Partner Auditor
BAF1	55	M	Bachelor Degree	27	Partner Auditor
BAF2	45	M	Bachelor Degree in Economics	8	Partner Auditor
CF1	38	F	Bachelor Degree	7	CFO
CF2	51	M	Bachelor Degree in Economics	27	CFO

Table 3: Characterization of the sample

Data collection was performed between April and August 2017, with an average duration of 20/40 minutes per interview. From the 9 interviews, 8 were made face-to-face at the auditors' workplace and 1 was by video call (Skype).

The interviews started with a brief explanation of the research objective of studying the perception of the impact of MAFR on four variables: audit quality, audit independence, audit market concentration and auditor’s opinion. After that the interviewees were asked some biographical data and then the semi-structured interview started with the use of open questions. Despite the existence of a script, the order of the questions was not always the same, changing with the course of the conversation, and new questions were introduced when necessary to clarify a certain aspect revealed by the interviewee. All verbal interviews were recorded and later transcribed for content analysis.

5. Results

The present chapter will present the main results obtained from the interviews to the statutory auditors and the clients, concerning the topic of MARF impacts. In order to be easier the understanding of the results, they will be aggregated into sections.

5.1. Auditor Independence

According to Cameran *et al.* (2005), the introduction of the obligation of audit firm rotation will bring more independence to the audit work. Audit will be conducted in a more unbiased way without an eventual pressure of a long tenure relation.

However, Shockley (1981) argued that more than being independent, it is important for the market to have this perception. In his work, the author showed that audit tenure doesn't have a significant impact on perceptions of independence, but small audit firms can be perceived as the companies having the higher probability of independence loss.

In order to perceive the influence in independence, the initial question was: "What impact do you expect to have on auditor independence?" and the answers were (table 4 and 5):

Interviewed	**Subcategories**	
	Increases	No direct relation
SAF1	X	
SAF2		X
SAF3	X	
MAF1		X
MAF2	X	
BAF1		X
BAF2		X
CF1	X	
CF2	X	
Total	5	4
%	55.56	44.44

Table 4: Perception of the impact on the independence of the audit

Interviewed	**Subcategories**	
	Increases	No direct relation
Small Audit Firms (SAF)	2	1
Medium Audit Firms (MAF)	1	1
Big Audit Firms (BAF)		2
Clients Firms (CF)	2	
Total	5	4

Table 5: Sum up of perception of the impact on the independence of the audit

As it can be seen in the synthesis carried out in the table 4 and 5, there is a diversity of opinions. However, an independence increase is perceived by the majority of the interviewees, there is not a general consensus between the auditors group.

Both clients firms agreed that the new legislation contributed to an increase of the auditor's independence, reinforcing the idea that an overly long relationship between the auditor and the client could be detrimental to ensuring the auditor's integrity and competence. Cameran *et al.* (2005) also pointed out this reason, reinforcing that the auditor is no longer under the client's pressure, conducting a more precise and objective audit.

Moreover, on the auditor's side there is not a consensus. Even more, four of the seven auditors said that MAFR has not a direct influence on the independence. Big audit firms agreed in that this new legislation has no impact on independence, but within the group of small and medium audit firms there is controversy, as can be seen in the following extracts:

- "*The new legislation reinforces independence. By changing the whole work team we are ensuring that there is no room for any pressure, with the final work being more impartial.*" **SAF1**

- *"We must be always independent. And independence also means not be financially dependent of a client, fact that our order and ISA's always pointed out. A client should never represent a certain percentage of the portfolio. (…) I would say that it contributes to a more marked independence, it alerts the auditee that there is such independence and* *that it is not possible to overthrow it and to the auditors, to us, that we have to be careful about our certification."* **SAF3**

-*"It may have some impact eventually in the year of rotation, but I'm not sure there's a direct effect. Independence should already exist, I believe this comes from people rather than rules. If the profile / organization is highly oriented to the issue of independence, I do not think it is by the rotation rule that this will influence. But it is also very important that an organization looks independent. And in this case I think that the rotation has this effect, providing that idea to the market. In my opinion, if the mandates were shorter, three / four years, had more scrutiny, exposed the auditors much more, and independence would be greater."* **MAF1**

-*"The fact that we audit the same client for a long time, even though we try to maintain independence and be rigorous in the work we do, the medium and long term perspective may allow us to speak and negotiate with the client some changes, however the client might not change them immediately. But now with rotation deadlines, everything comes in the report because no one wants to take unnecessary risks."* **MAF2**

-*"Under normal conditions, it should not influence independence because the auditor should remain exempt. However, I agree that over the years there may be a tendency for loss of independence. Regarding audit society, I believe that even if the team is maintained and the partner is running, that after some time, the degree of trust that may exist may lead to not innovating and not giving attention to some aspects that may seem well which are not actually well. I think that the lack of independence can be due to the routines and habits that can be created and the lack of innovation."* **BAF1**

-*"An audit relationship incurs risk of familiarity, an auditor who audits the same entity eventually creates ties that may overshadow the independence. But already before this legislation, there was the obligation of rotation of the member in charge of the work in order to assure the question of the independence. I am a bit skeptical about the fact that changing the auditing company will bring more independence. I do not think it's measurable, we can't establish a direct relationship. One of the objectives of the legislation is to increase independence, but I am somewhat critical of the fact that this actually limits dependency. However, the new legislation limits the provision of services and the weight of a certain entity in the portfolio, so there may be an increase in* *independence. But, there is no direct relationship. It is not because I have a financial dependence on a client that I will fail to comply with the auditing standards. In essence, the regulator wanted to arrange a set of measures so that the audit work be perceived by the market as independent, quality, competent and exempt."* **BAF2**

5.2. Audit Quality

There is not an agreement in the literature regarding the impact of mandatory rotation in audit quality. Some authors (such as: Myers *et al.*, 2004; Ghosh and Moon, 2005; Cameran *et al.*, 2012) defend that the lack of knowledge will have a higher effect, while others (the Commission on Public Trust and Private Enterprises, 2003, Carey and Simnett, 2006) affirm that a new audit team will bring a "fresh look" over the financial statements and over the main aspect of the companies. Even more, some authors, like Deis and Giroux (1992) or Bazerman *et al.* (2002), are in favor of MAFR, once that, as they proved in their work, a long audit tenure can influence negatively the audit quality.

Regarding to this topic, we asked: "What impact do you expect audit firm rotation to have on audit quality in the first year?" and the answers, table 6 and 7, were:

Interviewed	**Subcategories**		
	Improves	Decreases	No direct relation
SAF1		X	
SAF2		X	
SAF3	X		
MAF1			X
MAF2		X	
BAF1		X	
BAF2		X	
CF1			X
CF2			X
Total	1	5	3
%	11.11	55.56	33.33

Table 6: Perception of the impact on the quality of the audit in the first year

Interviewed	Subcategories		
	Improves	Decreases	No direct relation
Small Audit Firms (SAF)	1	2	
Medium Audit Firms (MAF)		1	1
Big Audit Firms (BAF)		2	
Clients Firms (CF)			2
Total	1	5	3

Table 7: Sum up of perception of the impact on the quality in the first year

As it is possible to observe in table 6 and 7, 55.56% of the interviewed believe in the occurrence of a loss in quality in the first year after rotation, but the clients do not expect such influence.

However, despite the fact interviewees disagreed regarding the impact in the first year, it is important to note that they were all in agreement about the long run improvement in the quality of the audit.

-*"There is indeed pressure from management that can influence the quality of the auditor's work. Rotation has a beneficial effect in that, at the time of the transition, the reviewer has to be especially sure that the accounts do not in fact have problems."* **SAF2**

-*"What is lost in taking some time to know the new client's structure, is gained in independence. Idea of being new at the company, I'm not clinging to old vices. By virtue of the statutes and today's ISA's, we are required to sign a contract with the entity. There is a contractual responsibility and prior to this, we are required to do a study of the company to find out what are the areas of significant risk. It is also important to realize with whom we relate, whether management and managers are capable and keenly aware of the rules. The new legislation warns of the nature of management and the importance of internal control. It has clearly improved auditing quality."* **SAF3**

-*"One of the assumptions is for the new auditor to meet with the client's previous auditor in order to discuss the entity's key risks and key aspects, and then, at the outset, the new auditor is positioned on key issues. I tend to think that there is a concern that in the first year there will be more quality and scrutiny because the main concern is to follow up the* *risks that had already been identified and try to diagnose/identify other risk situations. So, honestly, I would not say that quality is lost in the year of transition."* **MAF1**

-*"The first year is a year of investment in knowing the customer, we can characterize it by the sector but then each customer has its own particularities and somehow we do not have the total knowledge if not to the end of at least one year of relation with the customer."* **MAF2**

-*"In the early years, it is difficult to do audit work with quality, audit risk increases significantly. They are large organizations, with complex operations, some with great geographic dispersion, which makes it take a few years for the auditor to truly control operations."* **BAF1**

-*" Clearly, the new auditor in the first year has a gap of knowledge and it will take some time, some years, to reach a level of knowledge and experience in that entity, not only the numbers and risks of the business, but much in relation to the profile, behavior and ethics of the entity's management bodies. There is a loss of quality in the change because, whether we like it or not, even if audit firms allocate a large number of resources, in the first year, they would not be able to get the knowledge of the outgoing auditor. With the years and with the work, the knowledge is being improved and enriched, the auditor is gaining a greater sensitivity."* **BAF2**

-*"In the first year, there will be questions raised that were not in the past. The input level for us will be fruitful because it will be other eyes to see the same issues and sometimes there are approaches that are made that are distinct from the previous auditor. In our case, we had the same auditor a lot of time, almost 20 years. I believe the new auditor will be better. Not that we have complained about the previous auditor, but because they are "new eyes". Incidentally, we already noticed that when the audit team changed. So I think we're going to get some improvement, in the long term, which is limited, initially, by the lack of knowledge."* **CF1**

According to Myers *et al.* (2004), Cameran *et al.* (2012) and Ghosh and Moon (2005), rotation implies an additional cost. Thus, we expected that the audit firms and the audited entities had a perception that the new legislation will influence the costs.

In the interview we asked: "What impact do you expect the rotation of audit firms to have in costs?" and the answers were, as table 8 shows:

Interviewed	**Subcategories**	
	Influences cost	No influences costs
SAF1	X	
SAF2	X	
SAF3	X	
MAF1	X	
MAF2	X	
BAF1	X	
BAF2	X	
CF1	X	
CF2	X	
Total	9	
%	100	

Table 8: Perception of the impact on costs

Observing table 8, it's possible to verify that all the interviews agreed that MAFR will impact costs, but they all mentioned that it will not be significant. Both sides consider that the change implies a strong investment of time and resources, which has an implicit cost. As **BAF2** pointed out, cost is necessary to overcome the lack of information and the loss of quality in transaction. *"There is a strong investment in the first year due to the loss of quality in the transaction. In order to overcome this loss, I have to allocate a more robust team with more experience and more people and this has to have a higher cost with the startup of this client."* **BAF2**

The perception of audit firms is that in the first year the cost is due to the effort to get to know the company: its risks, its business, its environment and its internal controls. Also, in some cases, the audit team has to be reinforced, not only in number, but also in knowledge, having auditors with more experience in the field. The following extracts from the interviews prove this point.

-"*I believe there is a cost increase, but not a significant one. There is always work that has to be done in the first year, such as analysis of the company's environment, regulation and internal control. In the following years, there is only an improvement of what has already been done and, eventually, a review of the themes underlying possible audit alerts of previous years."* **SAF3**

-"*It is possible that there is an increment of costs but not significant. But if it is a society that lacks resources and has to go to the market to recruit, the price I believe is higher and in this case yes, there is an increase in costs."* **MAF2**

Regarding the public interest entities, the cost is related to clarify and help auditors to perceive how things work inside the company and the reasons behind the decisions implicit on the financial statements. Reinforcing this idea, **CF2** stateds the rotation will impact costs due to "*having to explain everything again in the first meetings with the new auditor".* Also **CF1** mentioned that "*are already feeling it because the new audit firm began work in June"* and there "*is a re-start of everything, there is no longer a routine. There has been a set of additional work on our part to respond to the requests of those who do not know us."*

5.3. Audit Market Concentration

One of the main goals of the adoption of the new legislation is the reduction of the market concentration in the big four. However, Cameran *et al.* (2012), in their work, evidenced that this goal is not achieved.

We asked the auditors and the clients:" What impact do you expect the rotation of audit firms to have in market concentration?" and, as shown in table 9, our results are aligned with Cameran *et al*. (2012). None of the interviewees expect an influence of MAFR in concentration. They mention that is expected to observe a dispersion in market shares, but always between the big audit firms.

Interviewed	**Subcategories**	
	Influences concentration	No influences in concentration
SAF1		X
SAF2		X

SAF3		X
MAF1		X
MAF2		X
BAF1		X
BAF2		X
CF1		X
CF2		X
Total		9
%		100

Table 9: Perception of the impact on audit market concentration

Also, medium audit firms don't see it as an opportunity due to the implicit risk, of performing audit to a public interest entity, and to the high number of resources involved, which they most probably don't have. However, even if only affecting the big four, there is an overall perception that it will be beneficial to the market.

MAF1 suggested that "i*f it were in force in Portugal join audits, instead of just being an audit firm",* one big and one small or medium audit firm auditing the same firm, for example, the concentration of audit market will decrease and, not only the client benefits from it, but also the whole audit market. **MAF1** said *"The big players in the market, those who generate the biggest fees, more public interest, more public opinion and more scrutiny will run between the big four, with rare exceptions. If it were in force in Portugal join audits, instead of just being an audit firm there were two, and there would be mutual self-regulation, there would be a better evaluation of the risk, the work to be developed, and there would be a greater debate, which tends to enrich. The more people get into the discussion, the more likely there will be more stringent procedures in the audit process. In this situation, there would be a dispersion of concentration and more players could enter and there would be a sharing of know-how".*

Concerning to others interviews, follows some extracts from their perceptions concerning to audit market concentration:

-"*I do not think that it is an opportunity for small audit firms or that it influences market concentration. The small auditor does not have this obligation in terms of turnover. In addition, the big audit houses, the big four, have other means. They invade the market by* *offering services in order to catch the customer. Small market players do not have the means to audit large clients such as public interest entities. They are entities that require means, above all human, in large numbers and very well trained to be alert to all possible problems."* **SAF3**

-"*Essentially among the big four, even because we are talking about large customers. But attention, even if it is just a reallocation between the big four, does not mean that it is not positive for the audit market in general."* **MAF2**

-"*Will not cause dispersion. Moreover, I do not know how small audit firms would provide a multi-geographical service or how would have a team of experts from different backgrounds. If I only have one client in one sector, I will not bring much value to it because I have no comparison term. But if you have multiple clients in the same industry, I can use the best of each of them to help others develop."* **BAF1**

-*"I think it's very relative. Whether we like it or not, there is a division in the market. The first division of the big four and the remainder in the second division. There's going to be a bigger distribution among the big four. Regarding to the second division to enter this market, I admit that yes, they may come in, but they are entities, from the point of view of resources, knowhow and skills, do not have much experience. Even for the client, moving from a big four to a small / medium society is risky. Moreover, the client itself, from what I have seen, has only been inviting other big four for auditing competition. That is why it is very relative if this will change the concentration. I admit that there may be an exception, but it is only within a very long timeframe that there can be evolution that will lead to some decentralization in the big four."* **BAF2**

As already mentioned in this report, an audit firm provides an audit service to a public interest entity is prohibited to provide a several type of works to the same audited entity, to its mother enterprise or to the entities over its control in the European Union. Some authors, as Gul *et al.* (2007) or Chung and Kallapur (2003), studied the relation between non-audit fees and audit independence. However, with the interviews, this study only intends to understand if audit firms perceived that the loss of a client in the audit area was compensated by the gain of the same client in other areas of the company. Small and medium audit firms are limited by the type of services offering to the customer, being that audit, in some cases, are the only service they provide. Henceforth, losing a client in the audit field, won't be compensated in other areas. However, public interest entities, with rare exceptions, are audited for big audit firms. The latter tend to have a diversified range of services available. Thus, interviews allowed to conclude that big audit firms perceived the loss of a client in the audit field, as an opportunity in other areas. Audit partners, losing a client due to the rotation obligation, provide that client information to the partner of other areas in order to keep him in the company. But, as **BAF1** warned, the loss of a client in a field and a gain of the same in other areas implies an efficient management of the resources available in the company.

-*"Audit firms with some size are beginning to expand service provision to address this issue."* **MAF2**

-*"They end up benefiting companies that have a wider range of services. In this case, the distribution is not so linear. While at the audit level, the large firms do not have significant differences in volume, in the additional services there is a very steep slope. Some companies do not participate in audit's tendering because it is more beneficial to continue providing the other services. Due to all the restrictions and risks, not always being a great customer auditor is attractive."* **BAF1**

-*"Portugal wanted to be even more restrictive in prohibiting the provision of a set of services. Somehow there may be a balance in the company, losing the customer in one area and gaining it in another. However, it depends on the type of services that the entity has to offer. There are entities that losing the client as an auditor, little else has to offer."* **BAF2**

5.4. Auditor's Opinion

Concerning the issue of an opinion, the final output of the auditor's work, as Melo (2014) already concluded in his study, this obligation will lead to a higher degree of opinion's qualifications. Therefore the following question was imposed: "What influence, if any, that as an auditor/client expect to occur in the issue of opinion?", and the answers are presented in table 10 and 11:

Interviewed	Subcategories	
	Influences auditor's opinion	No influences in auditor's opinion
SAF1	X	
SAF2	X	
SAF3		X
MAF1	X	
MAF2	X	
BAF1		X
BAF2	X	
CF1		X
CF2		X
Total	5	4
%	55.56	44.44

Table 10: Perception of the impact on auditor's opinion

Interviewed	Subcategories	
	Influences auditor's opinion	No influences in auditor's opinion
Small Audit Firms (SAF)	3	
Medium Audit Firms (MAF)	1	1
Big Audit Firms (BAF)	1	1
Clients Firms (CF)		2
Total	5	4

Table 11: Sum up perception of the impact on auditor's opinion

Through the analysis of tables 10 and 11, one can conclude that the majority of the interviewed (55.56%) perceive that MAFR will influence the auditor's opinion. However, the clients, who agree among themselves, don't share the same opinion with the majority of the auditors.

The audited entities don't perceive an influence in auditor's opinion, as **CF1** referred: *"typically, we only work with the big four and the quality standards and work are very identical so I do not anticipate that there will be any kind of influence"*.

Regarding audit firms perceptions, there is no agreement concerning the final impact on the issue of an opinion. Moreover, one can conclude that the perception of auditors is influenced by the size of the audit firm. While the auditors from small audit firms agree that MAFR will influence, the remaining auditors share some opposing opinions. The following excerpts from the interviews mirror these different positions:

-"*The financial crisis began in the stock market. There is a very big warning in telling the truth about the financial statements of public interest entities. These are quite sensitive, so they should be audited independently and in full. Twenty years ago the society did not know what a chartered accountant was, and nowadays it plays a very important role. The auditor has to act according to the new legislation that is beneficial not only for the market, but for the whole society.*" **SAF3**

-*"The new auditor may take a different position from the previous one and this is what may impact the completion of the work. The outgoing auditor has certain "gray" situations of discussion that he has had with his client and certain positions he has taken that lead him to accept certain practices and their conclusion and opinion."* **BAF2**

5.5. Final Balance

In the literature review, there is not a final agreement regarding the main impact of MAFR. Hereupon, the final question of the interview aimed to perceive what were, if any, the others advantages/disadvantages of this legislation and if, in a global sense, this is benefit for the whole audit market. And the answers were (table 12):

Interviewed	**Subcategories**	
	Positive	No influence
SAF1	X	
SAF2	X	
SAF3	X	
MAF1		X
MAF2	X	
BAF1	X	
BAF2	X	
CF1	X	

CF2	X	
Total	8	1
%	88.89	11.11

Table 12: Perceptions of the final balance of mandatory rotation

Analyzing the table 12, 88.89% of the interviewed consider that the obligation of rotation is positive. **MAF1** *"don't believe that the isolated question of the rotation has great influence",* but "*globally, all measures taken by the government have a positive impact on the audit field".*

The remaining participants pointed out advantages already mentioned in the literature review, such as: more competence, more credibility, a "fresh look" over the financial statements and to avoid familiarity. As can be seen in the following extracts:

-*"Everything that is quoted on the stock exchange, with high social responsibility, has to have turnover and the legislation has to be very demanding. All legislation that obliges entities not to create dependency relationships, not to subjugate them at the level of fees and that prevents the traffic of influences is beneficial. I am in favor of everything that can be done to ensure competence and independence."* **SAF3**

-*"I see rotation as a good practice, to avoid links with audit teams."* **CF2**

Concerning to the disadvantages, besides the possible impacts on the variables already studied, **BAF1** alerted to the management of the resources:

-*"One of the major disadvantages of rotation is the management of resources within organizations. An audit firm with large clients if they lose two or three clients at the same time, what make the people in charge of this project? And who earns these customers? Are you going to recruit? It ends up having two problems: lack of knowledge of the new client and lack of resources."* **BAF1**

Also, **CF1** consider that the fact of audit firm change, the relation between the audit firm and the audited entity can be compromised:

-*"One of the disadvantages is the investment that needs to be made each time you move. We all know that we are in a relationship with term which ends up limiting the level of trust between both parties. In addition to that the audit team ends up not having a deep* *knowledge of ours and we ended up not feeling the same comfort. On the other hand, rotation allows new approaches and gives space to issues that in a stable situation may not be posed. I also believe that even within the big four, rotation will allow them to thrive and grow."* **CF1**

6. Conclusion

This study aimed to assess the perception of audit firms and audited entities concerning the impact of MAFR on audit quality, audit independence, audit market concentration and on the issue of an audit opinion. Despite the high number of studies in the literature review regarding these four variables, aforementioned, few of them have studied the impact of MAFR on them. Moreover, there is a lack of research having as base Portuguese data, and, in addition, there is not a consensus among the several authors regarding on the topic. While some authors are in favor of the obligation of audit firm rotation and defend that it will bring benefits for the audit sector (Bazerman *et al.*, 2002, Davis *et al.*, 2009, among others), others defend that benefits are not clear and that the inherent cost of this directive can be higher than the expected (Myers *et al.*, 2003, Ghosh and Moon, 2005, among others).

Hereupon, this investigation intended to fulfill a gap in the literature, by providing evidence of the perception of Portuguese audit firms (of different sizes) and audited entities on the impacts of the MAFR. Thus, nine people were interviewed, seven auditors and two clients, and their perceptions were studied.

The results showed that MAFR is perceived as an improvement of audit independence by the clients, but auditors did not expect that it will influence their independence. Concerning quality, clients defend that MAFR won't have influence, despite the fact that the majority of the auditors perceived that, in the first year, a decrease on quality is perceived. However, auditors and clients agreed that in the long run, an improvement of quality will be noticed, while, concerning the costs, the perception is that the obligation of change the audit team will influence it, but not significantly. Also, this new legislation is not perceived has having impact on audit market concentration, being it is influence related to the dispersion of market shares between the big four. Lastly, concerning the issue of an opinion, in the clients' perspective MAFR is not perceived as having impact, while auditors defend that it will produce an influence.

Moreover, this study allows to conclude that the size of the audit firm don't influence the perceived impact in terms of costs and market concentration.

Besides the Italian example alerted for the hypothesis of MAFR not be the best solution of the European audit market, in order to enhance auditor's independence and the quality of the audit work, our findings reinforce the relevance of the legislation once the majority perceived it has being benefic to the audit market.

The approach presented in this research presents limitations. This is an exploratory study once legislation in cause is recent, the information is limited by existing few studies regarding the real effect of MAFR. Even more, the study considered a small sample, due to the adherence of participants.

Further research is clearly needed and should be extended to more companies. Also, it will be interesting to study the impact of this legislation in audit quality measured, for example, through the earnings managements.

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Annexes

Annex 1 – Interview Questionnaire to the Audit Firms

Name:

- **Sociodemographic Characterization**

Age:

Gender:

Academic Qualifications:

Years of Statutory Audit:

Job:

- **Questions**

Auditor's Independence:

- What impact do you expect to have on auditor independence?

Audit Quality:

- What impact do you expect audit firm rotation to have on audit quality in the first year?
- What is the expected impact of the lack of knowledge of the client, business and industry on the quality of the audit work?

Audit Market Concentration:

- What impact do you expect the rotation of audit firms to have in market concentration?
- Will the rotation of audit firms be an opportunity for small market players?
- Audit firms rotation leads to loss of customers. Is it expected that the loss of customers in audit field leads to compensations, from the same customer, in another area (which was previously prohibited service)? Or is a "cut of relations" between the company and the client expected?
- For small and medium audit firms: Due to the size of the audit firm, is there an interest in staying with the big clients that the big four are losing?

Other Aspects:

- What impact do you expect the rotation of audit firms to have in costs?
- What influence, if any, that as an auditor expect to occur in your opinion?

- Does the rotation of audit firms make sense in general? Is it seen as an opportunity or a threat? Are there any other advantages / disadvantages you would like to mention?

Annex 2 – Interview Questionnaire to the Audited Entities

Name:

- **Sociodemographic Characterization**

Age:

Gender:

Academic Qualifications:

Years of working in the Public Interest Entity:

Job:

- **Questions**

Audited Companies/Clients:

- What impact do you expect audit rotation to have on quality?
- What influence, if any, that as a client is expected to occur in the issue of opinion?
- What are the advantages and disadvantages it provides the mandatory rotation of audit firms?