AUDITING VERSUS CONSULTANCY: A CRITIQUE OF THE EU LAW REFORMS ON THE NEW FORM OF AUDITING

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Abstract

Auditors used to serve the interest of the shareholders only. However, there have been significant changes in terms of auditors' role and their function. Auditors are now expected to verify financial statements, but at the same time give an assurance regarding the financial sustainability of the entity. Regarding the latter role, audit firms provide consulting services, including risk assessment and management services. However, the law does not assign the latter role to external auditors. This situation results in an expectations gap in relation to both the role of the auditors and the scope of the external auditing. In addition, the growing economic importance of consulting and the long years of auditor tenure is likely to impair auditor independence. This paper submits that the new form of auditing is not problematic but creates issues. First, the expectations between the users of the financial reports and auditors are wider. Second, auditors' independence is damaged due to the long years of auditor tenure and dependence of non-audit fees generated from consultancy services that not related to audit. The recent law reforms issued by the European Commission has brought some important provisions in terms of filling the expectations gap, reinforcing auditor independence and reducing the familiarity threat. EU's relatively strict rules on provision of non-audit services and audit firm rotation are expected to have an important impact in the audit market. A critical analysis of the new EU law is submitted with some policy recommendations.

Keywords: Auduting, Consultancy, Reforms, EU Law

1. NTRODUCTION

Since the 1200s, and the early development of firms, auditing has existed (Watts and Zimmerman, 1983). External auditing was first used to check on managers on behalf of shareholders, in the manner of detectives (Shapiro, 2004). As a result, auditors used to serve the interest of the shareholders only. However, there have been significant changes in terms of auditors' role and their function. Users of audited reports have been extended beyond shareholders. Today, external auditing is necessarily important for investors, but also depositors, regulators, suppliers, creditors, and anybody who is likely to use audited financial reports, thus assigning a public role to auditors as gatekeepers of sorts (Shapiro, 2004; Coffee, 2006).

External auditing refers to the relationship where corporate management hires an independent external auditor to review and approve annual financial statements. Annual financial statements include the balance sheet and the related statement of income, retained earnings and cash flow for the completed fiscal year (Ronen, 2010). Financial audit is the process of checking the accuracy of these annual financial statements and compliance with the related accounting standards (Ronen, 2010).

In the EU, it is a legal requirement that listed companies' financial statements should be audited by an independent external auditor (Directive 2006/43/EC - as amended). Member States' competent authorities approve statutory auditors (natural persons) or audit firms (legal persons) to perform statutory audits at the national level (UK, Companies Act. 2006, section 489). For instance, in the UK, only statutory auditors recognized by supervisory bodies, such as the Institute of Chartered Accountants of England and Wales (ICAEW), are allowed to perform statutory audits of public companies (UK, Companies Act. 2006, section 1212). In general, the statutory audits of PIEs are provided by the audit firms rather than individual statutory auditors. Auditors have to apply certain standards, e.g. IFRS, ISAs, auditors' code of ethics (IFAC, 2010), when they perform audits of publicly listed companies. In addition, they are subject to regulatory supervision of public oversight authorities, e.g. PCAOB in the US and FRC's Audit Quality Review (the former Audit Inspection Unit) in the UK.

The audit process is constituted of three main stages. In the first stage, the auditor gains understanding of the audited company and its activities through assessment of accounting system and internal control mechanism (Porter, Simon, and Hatherly, 2003, p. 149). This stage involves evaluation of internal controls in detail, as to whether the transactions and account balances are parallel to company records and whether there are any material misstatements. If the auditor is satisfied with the accuracy of internal control records from the evidence gathered from stage one, he (or she) continues with the second and final stage, to issue the audit report. However, if the auditor finds additional risk factors, such as asymmetric records with the transactions and internal control reports, then the scope of the audit is reset (Ronen, 2010, p. 191). In the third and final stage, the auditor issues an audit report to provide information to shareholders and other third parties. The auditor's opinion on the financial statements is meant to provide a reasonable assurance on whether financial statements are free from material misstatement caused by fraud or error, and whether they are in accordance with the related accounting standards and laws (ISA 700, para. 10). The auditor's opinion should also note any circumstances that may affect the financial stability of the audited entity.

If the auditor is satisfied with the audit evidence, and that the financial statements give a true and fair view, and they are prepared in compliance with the relevant accounting standards and legislation, she issues an unqualified audit report (ISA 700, para 16). If unqualified, this audit report is a 'clean' audit report. The auditor may also decide to issue a qualified audit report due to misstatements in the financial statements or because she was unable to obtain sufficient evidence about the accuracy of the financial statements. Before issuing a qualified audit report, the auditor needs to modify the opinion in the report (ISA 700, para. 17). There are three types of modified opinions: a qualified opinion, an adverse opinion, and a disclaimer of opinion (ISA 705, para. 2). If there are material misstatements, but there is nothing pervasive to the financial statements, the auditor issues a 'qualified opinion' (ISA 705, para. 7). This is still a clean opinion. If the misstatements are material and pervasive to the financial statements, the auditor expresses an 'adverse opinion' (ISA 705, para. 8). This is an unclean audit opinion. Lastly, the auditor may issue a disclaimer of opinion when she is unable to obtain sufficient appropriate audit evidence regarding the accuracy of financial statements (ISA 705, para. 9). The auditor disclaims the audit opinion because of the risk that undetected misstatements could have a material and pervasive effect on the financial statements.

2. DUAL ROLE OF AUDITORS

The history of auditing dates back to the early development of joint stock companies.[111] In the UK, this occurred with the enactment of the first Companies Act (Joint Stock Companies Act) of 1844, which recognized audit for English companies on a voluntary basis (Watts and Zimmerman, 1983, p. 628). The Companies Act of 1900 required audit for the first time; however, it did not define any rules to determine an auditor as qualified to perform audits (Porter, Simon, and Hatherly, 2003, p. 22). Thereafter, auditing did not develop as a profession in the UK until 1948 (Cosserat 2000, p. 5). Before then, directors or officers appointed by shareholders performed the audits of early joint stock companies (Watts and Zimmerman, 1983, p. 624). In line with its development, the objective of auditing has evolved over time.

2.1 Auditors as Detectives (Public Watchdogs)

During the late 1890s, in the early days of auditing, the objective of an audit was to check the consistency of internal records (book-keeping of company transactions) of the company (Cosserat, 2000, p. 6). This role mainly involves the detection of fraud and material errors in the accounts (Dicksee, 1892). As a result, auditors were only responsible to the company that they audited (Shapiro, 2004, p. 1034). The role of the detective-auditor was mainly to serve the owners of the company by confirming the consistency of internal records with the company transactions and to make sure that the treasurer was not cheating the owners.

The fraud detection role of auditors was also acknowledged in case law in the UK. The two cases of *London and General Bank (Re London and General Bank (No.2) 1895)* and *Kingston Cotton Mill Co Ltd. (Re Kingston Cotton Mill Co. (No.2) 1896)* re-stated an audit's objectives of detecting fraud and error. These cases also stated that auditors could not be expected to detect every fraud and error (*Re London and General Bank (No.2) 1895)* since they are watchdogs but not detectives or bloodhounds; they do have to show reasonable skill and care in their work, however (*Re Kingston Cotton Mill Co. (No.2) 1896).*

2.2 Auditors as Certifiers (Gatekeepers)

In the 1970s, by the time of the development of the securities markets, small investors needed more information regarding the fairness of financial information included in companies' statements. Auditors were asked to approve information to be disclosed to a third party, namely to shareholders, investors or in general, to the public. Correspondingly, the objective of auditing moved from fraud detection towards ensuring the credibility of financial statements (Carmichael, 1974). From that time, providing assurance services was recognized as the primary role of auditors, while detection and prevention of fraud were assigned to the internal control mechanism designated by the management (Porter, Simon, and Hatherly, 2003, p. 27).

By the 1990s, the business risk approach was adopted in auditing (Porter, Simon, and Hatherly, 2003, p. 32). The business risk approach holds that audit failures[112] are not generated because of undetected fraud or error, but because of the uncontrolled operational risks in a company (Porter, Simon, and Hatherly, 2003, p. 33). Accordingly, in order to reduce the business risk, auditors started to focus on the provision of consultancy services and they acknowledged their responsibility to provide an opinion as gatekeepers regarding a firm's ability to continue as a going concern.

[111] As it was translated from the original Medieval Latin text, in 1200, a constitution of English merchant guild (an early example of association of traders) at Ipswich had a provision for annual audit. See Charles Gross, *The Gild Merchant* 4 (1890) in Watts and Zimmerman, 1983, p. 616.

[112] Audit failure refers to issue a clean audit opinion on financial statements that are materially misstated.

3. MODERN AUDITING PROFESSION

Today, auditors are seen as gatekeepers (or certifiers), rather than detectives. From a gatekeeper's perspective, the objectives of modern auditing can be considered to be the provision of a review of the company's accounts, to examine financial statements to ensure they are free from material misstatements, omissions and misleading information, and to express an audit opinion including any concerns regarding a firm's ability to continue as a going concern.

Public companies are required to disclose financial information to the public once shares are offered, and for as long as they are traded on stock exchanges (Directive 2004/109/EC – as amended, Articles 4 and 6). Auditors then review and certify the financial information disclosed to third parties. There are a number of users of this verified financial information: namely, the existing company shareholders, potential shareholders (investors), regulatory agencies, and any third party that might be involved in the operations of the company. Investors use the audited financial information to decide whether to make an investment in the company. Regulatory agencies seek the efficiency of financial markets through accessible reliable and sound financial information. All of this has the aim that stock prices reflect companies' present reliable information and that the market determine the correct prices of securities (Shapiro, 2004, p. 1041).

However, this dual role of auditors might cause conflicts of interest. On the one hand, auditors have to perform an auditor-as-detective role to the company owners (existing shareholders). On the other hand, certifier auditors verify disclosed financial information and approve financial stability - whether it is financially sound to invest in the company. Though detective-auditing has a public watchdog role, certifying auditing may give auditors an incentive to please the client instead of protecting the interest of the public.

In certification auditing, public companies hire auditors to verify the disclosed financial information so that they can induce the potential investors to make investments in their companies. Here, there is a risk that the auditor might favor the company, even though the user of this information is a third party (potential investors). There is a risk that the auditor might become an advocate of the company, instead of acting like an impartial detective, and serving their public watchdog role (Jenkins and Lowe, 1999). This conflict of interest arises naturally because of the auditor-client relationship, i.e. auditors are hired and paid by the audited company (the client), and they have an incentive to please their clients.[113]

Furthermore, auditing is now extremely focused on adding value to the audit (Jeppesen, 1998). Value-added services include detecting, understanding, and analyzing the business risks that the audited firm is involved in, and building a strategy to manage and control those risks (Jeppesen, 1998, pp. 522-525). Value-added auditing is delivered in the form of consulting. Consulting includes strategic management planning, internal audit outsourcing services, risk assessment business performance, and e-commerce to name but a few. Today, it is common that audit firms provide advisory services in addition to the traditional form of audit (i.e. the verification of financial statements). In fact, it has now become the case that, because the fees generated from the audit are lower, auditors are seeking to provide non-audit services to the same client or to non-audit clients (Max Planck Institute, 2012, p. 5) . This situation is called 'lowballing'. Via lowballing, auditors seek to compensate for low audit fees through the provision of consultancy services for higher fees. Revenues generated from advisory services form an important part of the revenues of the Big Four audit firms. To give an example, as of 2015, 37.47 % of the global total revenue (US$ 45.455 billion out of US$ 121.3 billion) of the Big Four is generated by advisory services.[114]

The provision of non-audit services to an audit client, namely advisory services, builds an economic relationship with the client (Jeppesen, 1998, p. 525). When the auditor gives advice on the business of the client, the auditor gains an interest in the financial success of the client (Mautz and Sharraf, 1961, pp. 268-269). There is therefore an economic interest for auditors in the provision of consulting services. As a result of the growing importance of advisory services, auditors became less dependent on reputations for high-quality auditing (Coffee, 2002) and more dependent on their relationships with the client for the sake of consulting services (Briloff, 1990).

The growing economic importance of consultancy services converts auditing into a new form of doing business. This new form of auditing builds a mutual economic interest between auditor and client. As results, auditors primarily consider the business demands of the clients, and consider less the interests of the users of financial statements (Jeppesen, 1998, p. 525). This new form of auditing might result in independence issues. Auditor independence requires the absence of economic interests that could cause a conflict between auditor and client. Economic interest in an audited company makes it difficult for auditors to perform independent auditing: there is a risk of 'self-serving'.

4. PROBLEMS WITH THE NEW FORM OF EXTERNAL AUDITING

4.1 Does the public expect too much from auditors?: the expectations gap

Auditors are not only asked to perform a detective-auditor role, but they are also called to consider the business risks which includes the assessment of whether an entity will fail to achieve its objectives (Tatum and Stuart, 2000). There is a general perception among stakeholders that financial statements with unqualified audit reports guarantee the financial health of the entity (Valukas, 2010). However, audit opinion does not have to give such

113 In a study, a group of business students were assigned to be the auditors of a fictional company A. The other group assigned as auditors of another fictional company B that wants to take over the A. The figures of the sellers' auditors show higher value than the figures of the buyers' auditors. See (Shapiro, 1984, p. 1041).

114 Data extracted from the global annual review reports of 2015 of the Big Four audit firms.

assurance regarding the future sustainability of the entity.

The number of collapses and major fraud incidents called for increased accountability and hence, changes in perceptions of auditors' role (e.g. the Arthur Andersen's financial chicanery in Enron case). Nevertheless, auditors are not primarily responsible for the prevention and detection of fraud; instead, this role falls to the management (ISA 240). Auditors are required to show reasonable skill and care to detect and report fraud (*Re Kingston Cotton Mill Co. Ltd. (No.2)* 1896). The term 'reasonable' causes ambiguity, however, and therefore results in an expectations gap regarding the stakeholders' understanding of the duties of auditors.

As UK case law has recognized, it cannot be expected of auditors to detect every fraud and error in financial statements (*Re Kingston Cotton Mill Co. Ltd. (No.2)* 1896). It is likely there would be undetected material misstatements in the financial statements even if the auditor showed reasonable skill and care. Moreover, capital markets become more sophisticated and complex every day. It is true that neither regulators nor auditors fully understand today's complex financial markets (Leeson, 2007). It gets more difficult for auditors to audit effectively and provide an assurance in such complex markets (Sikka, 2007).

4.2 Dependence on non-audit fees: impaired auditor independence

In capital markets, investors use a company's financial statements in determining their investments, so as to make the highest return on their investment with the lowest risk (Healy and Krishna, 2001). There is a possibility that managers will accidently - or deliberately - misrepresent financial statements. Thus, external auditors as are needed as independent outsiders to assure investors that financial statements prepared by the management are presented accurately. Investors consider external auditing as an assurance regarding the reliability of financial statements only because external auditors have professional qualifications and knowledge and they are independent of the management. If auditor independence were impaired, their financial statements will no longer be trusted.

The professional qualification of an auditor is important for detection misstatements and errors in the financial statements, so that the accuracy of the financial statements is ensured. DeAngelo defines audit quality as the auditor's ability both in discovering corruption in financial statements, and in reporting it (DeAngelo, 1981, p. 186). An auditor is only able to detect fraud if she has the professional qualification(s), knowledge, and experience to perform an audit (Flint, 1988, p. 48). Auditors' ability to report a breach or misrepresentation in financial statements depends on her independence (Citron and Taffler, 1992, p. 344). If the auditor is not independent, she will have no incentive to express their competence to detect fraud.

Nevertheless, independence is an ambiguous concept; it is not easy to ensure. In the existing literature, auditor independence is analysed according to two concepts: independence 'in fact' and independence 'in appearance' (Dopuch, King and Schwartz, 2003). The former concept refers to the attitude of being impartial and objective, while the latter refers to the perception of independence by users of financial statements, namely shareholders and investors (Dopuch, King and Schwartz, 2003, p. 84). Auditor independence can be ensured in a number of ways. First, auditors, as certified public accountants, are subject to professional discipline and the oversight of national public bodies (e.g. the Conduct Committee,[115] part of the Financial Reporting Council (FRC) in the UK). Second, auditors are required by law to be independent meaning that there may not be any close ties to, or financial self-interests in the audited company (Directive 2006/43/EC – as amended, Article 22(2)).

The audit contract is signed between the auditors and the managers of the audited company who actually pay the auditors with the financial resources of the company. Audit firms are inherently commercialised institutions that seek to increase their profits and market share and therefore, they might forget their actual clients and become capitalist institutions simply trying to maximize their profits. As a result, there is a risk that they are not able to deliver independent audits when they are dependent upon company directors for their fees and have an incentive to please the company management, in order to secure their non-audit fees.[116] This situation might suggest that auditors would avoid disputes in order to be reappointed (or not to be dismissed).

Even if the auditor is independent 'in fact', they have to show this independence to the public. Being independent 'in fact' is an ambiguous concept and difficult to interpret in practice, because it depends upon auditors' mentality in their audit work (Richard, 2006, p. 156). Even though it might not be possible to prove mental independence to the public (i.e. objectivity), there are a number of ways to evaluate the degree of independence 'in appearance'. These are: auditors' dependence on non-audit fees, the length of auditor tenure, and the competitive environment, i.e. the choice of auditor (Arnold, Bernardi and Neidermeyer, 1999). The provision of consultancy services and dependence on non-audit fees may impair independence 'in appearance'.

4.3 Long years of auditor tenure: the familiarity threat

The 'familiarity threat'[117] is explained as where the auditors have been involved for many years in audit engagements. The long years of auditor tenure could make auditors less skeptical because of an ongoing relationship with the client and this may cause auditors failing to spot misrepresentation in financial statements because she would be looking

[115] The duties of the Professional Oversight Board are assigned to the Conduct Committee.

[116] Ronen indicated a saying to highlight the independence issue of auditors; '*whose bread I eat his song I sing*" (Ronen, 2010, p. 189).

[117] Familiarity threat may occur due to a long or close relationship with a client where in professional accountant becomes too sympathetic to the interests of the client (IFAC Code of Ethics 2010; para. 100.12).

from the perspective of their client (Arnold, Bernardi and Neidermeyer, 1999, p. 50; Klimentchenko, 2009).

The Directive 2006/43/EC required the key audit partner to be rotated every seven years (Directive 2006/43/EC – as amended, Article 42), however it did not state any rotation rules for audit firms. Hence, it is common across EU listed companies to have the same audit firm for many years. For example, according to a survey, it is common in the EU (except in Italy)[118] to have the same audit firm for more than 7 years (London Economics, 2006, p. 73). Having the same audit partner for many years is also evident in the UK financial markets where the average tenure rate for FTSE 100 companies is 48 years on average (House of Lords, 2011, p. 13).

The trend to have the same audit firm for many years is hazardous for auditor independence in a number of ways. First, this situation might impose pressure on auditors not to lose the client, say in the UK market, for another 48 years on average. Because of this pressure, it would be difficult for auditors to carry out statutory audits with a questioning mind (i.e. professional scepticism), which involves critical evaluation and questioning existing information in the financial statements provided by the management. Therefore, they would be reluctant to detect and report errors in the financial statements.[119]

5. AN OVERVIEW OF THE EU LAW REFORMS IN TERMS OF THE PREVAILING PROBLEMS IN THE AUDIT MARKET

The global financial crisis of 2008 witnessed not only the failure of banks and financial institutions but also the failure of auditors (Sikka, 2009). This has damaged the reliability of financial statements and statutory auditors. As a response, in October 2010, the European Commission issued a Green Paper entitled 'Audit Policy: Lessons from the Crisis' that emphasised the role of the auditors in financial markets and their relation to the financial crisis (European Commission Green Paper, 2010). Following the Audit Green Paper, in November 2011, the European Commission issued two law proposals: a Directive to enhance the single market for statutory audits (Directive 2014/56/EU - amending Directive 2006/43/EC) and a Regulation to increase the quality of audits of financial statements of Public Interest Entities (PIEs) (Regulation No. 537/2014). Both law proposals came into affect on May 2014.

PIEs often involve cross-border activities across the EU. Audit practices and regulation in Member States, however, are not homogenous, but have different auditing standards and different approval/registration rules for auditors and audit firms. This situation creates a high administrative burden on the audit of PIEs. Therefore, regarding the audit of PIEs, a separate legal requirement was suggested (European Commission Impact Assessment, 2011, p. 9). Although the general requirements for a statutory audit of PIEs (i.e. the requirements for the registration/approval of auditors) dealt with the existing Directive 2006/43/EC (as amended by Directive 2014/56/EU),[120] the specific additional requirements regarding the conduct of statutory audits of PIEs were set by this Regulation. Hence, the revised Directive and the Regulation must be read together.

5.1 Filling the expectations gap

It has long been the subject of a number of discussions as to what sort of information auditors should be providing to stakeholders.[121] It is highlighted that users cannot find what they are looking for in auditor reports since the most common audit opinion is a "*template*", (European Commission Impact Assessment, 2011, p. 13) providing a standard content.

Previously the law did not refer explicitly the content of the audit reports however, both the Directive 2014/56/EU (amending Directive 2006/43/EC) and the Regulation No. 537/2014 now govern what needs to be included in the audit report. Accordingly, audit reports shall indicate that the statutory audit was conducted in accordance with ISA (Directive 2006/43/EC – as amended, Article 28(1)), identify key areas of risk of material misstatements in the financial statements (Regulation No. 537/2014, Article 10(2)/c-i), explain to what extent the statutory audit was designed to detect irregularities, i.e the fraud (Regulation No. 537/2014, Article 10(2)/d), declare the prohibited non-audit provisions were not provided (Regulation No. 537/2014, Article 5(1)) and that the statutory auditor(s) or the audit firm(s) remained completely independent (Regulation No. 537/2014, Article 10(2)/f). Also, in a separate audit report, auditors shall provide a statement on the situation of the entity especially on the assessment of the entity's ability to stay as a going concern (Regulation No. 537/2014, Article 11(2)/i).

5.2 Reinforcing auditor independence

Auditor independence is one of the key elements reflecting the reliability of financial statements. An auditor's ability to reflect her professional judgement freely on the audit report is also necessary for audit quality. However, some auditors might be involved in certain situations where independence is impaired due to a conflict of interest. The provision of certain types of non-audit services, such as bookkeeping and tax consultancy for example, could impair auditor independence because there is a risk in this situation that auditors become more dependent on non-audit fees (Briloff, 1990).

There is no homogeny regarding the provision of non-audit services to the audit client in the EU, since Article 22 of previous Audit Directive

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118 In Italy, there is a regulatory requirement for mandatory rotation for audit firms every 9 years. See (European Commission Impact Assessment, 2011, p.170).

119 Also, auditors who have long-tenure tend to be reluctant to make adjustments regarding errors in the prior audit periods because this would mean admitting past mistakes (Bazerman, Loewenstein, and Moore, 2002).

120 Articles 39 to 44 and 22 (2) of the Directive 2006/43/EC will be deleted to be integrated to the Regulation on specific requirements for the statutory audits of PIEs.

121 For a brief history of the last 100 years of the expectations gap, see Humphrey, Moizer, and Turley,1992.

2006/43/EC has been interpreted differently by Member States. Directive 2006/43/EC states that the auditor shall not carry out a statutory audit if there is any direct or indirect financial, business, employment or any other relationship between the auditor (or audit firm) and the audited company (Directive 2006/43/EC – as amended, Article 22(2)). Directive 2006/43/EC granted Member States discretionary powers to take necessary steps to ensure the appropriate safeguard on the auditors' independence. As a result, Member States take different approaches in terms of the provision of non-audit services. For instance, the French Code of Ethics banned the provision of non-audit services (French Code of Ethics, Articles 10, 23, and 24; ESCP Europe, 2011, p. 154), while the UK's approach is less restrictive since there is no such ban with respect to the provision of non-audit services to the audit client.[122] Therefore, it is common in the UK that audit firms, including the Big Four, offer consultancy services to their audit clients,[123] and listed companies disclose fees paid to auditors for those services (UK, Companies Regulation, 2008 No. 489).

Although certain types of non-audit services not related to the audit work can impair auditor independence, it is claimed that provision of non-audit services can improve auditors' skills and knowledge, and this may enhance their audit quality in general (Lennox, 1999). It could be suggested that auditors should not be forbidden to provide all consultancy services to the audit clients. However, it might be necessary to divide non-audit services into categories with respect to their degree of threat to auditor independence.

The first category is the type of non-audit services that have a direct impact on the accounts, these services are consultancy services that are not related to audit and will have a direct impact on auditor independence. In the recent law reforms, the European Commission strictly banned the provision of this type of non-audit services. These services are outlined in Article 5(1) of the Regulation No. 537/2014: bookkeeping, payroll services, legal services, services related to the audited entity's internal audit function, and human resources services.

The second type of non-audit services can be necessary for auditors to perform the audit work more effectively, e.g. tax services and valuation services (Regulation No. 537/2014, Article 5(1)/a/i, a/iv to a/vii and f). The provision of this type of services can be allowed by the Member States if these services have no direct effect on the audited financial statements and the independence of the audit firm and the auditor are secured (Regulation No. 537/2014, Article 5(3)/a/c).

The third category includes services that are termed audit-related financial services, encompassing services required by legislation or contract to be undertaken by auditors.[124] The provision of non-audit services is necessarily problematic when non-audit fees are higher than audit fees. This situation can increase auditor dependency on non-audit fees and hence, mitigate independence.[125] Therefore, the total fees for non-audit services other than those referred in Article 5(1) of the Regulation No. 537/2014 shall be limited. Accordingly, the total fees for such services shall not exceed 70 % of the average fees paid in the last three consecutive financial years (Regulation No. 537/2014, Article 4(2)). Furthermore, when a substantial part of an audit firms' revenues (i.e. 15 %) originate from a single audited entity the auditor shall disclose the fact with the audit committee and consider the treats to their independence (Regulation No. 537/2014, Article 4(3)).

5.3 Reducing the threat of familiarity

Long and close auditor engagements with the same audit firm are likely to jeopardize auditor independence because there is a risk of getting overfamiliar with the audited company. Key audit partner rotation by itself is not enough to reinforce auditor independence. In order to reduce the threat of familiarity, two types of auditor rotation might be suggested: internal and external rotation. While internal rotation allows a different audit partner from the same audit firm to engage in the audit for the next period (tendering), external rotation requires a change of audit firm (rotation).

In addition to tendering (rotation of the key audit partners every 7 years – with a three year cooling period), the Regulation No. 537/2014 has brought a mandatory rotation policy for audit firms (Regulation No. 537/2014, Articles (7) and (4)/b). In this respect, audit firms would no longer be appointed for many years, but the maximum duration will be 10 years (or 24 years in case of joint audits), including the renewed engagements (Regulation No. 537/2014, Article 17(1)). In addition, there shall be a four years gap (cooling period) if the same audit firm were to be appointed after the maximum period of ten years (Regulation No. 537/2014, Article 17(3)).

6. CONCLUSIONS AND RECOMMENDATIONS

It is true that financial scandals and crises give lawmakers opportunities to regulate the market. While crisis time regulations were seen as lifesavers during the crisis time, there is a risk that they have become an over-reaction to corporate scandals and not be effective, but represent only symbolic actions (Tomasic and Akinbami, 2011, p. 272-273). As for the European Commission's law reforms, it is important that they provide a practical response to the issues, rather than following a regulatory routine (Kandemir, 2013). Although time will tell as to when

[122] Auditing Practices Board (APB) Ethical Standards state that audit firms should consider any possible threat to independence when accepting a proposed engagement with non-audit services (APB Ethical Standard 5 (Revised), para. 14).

[123] For instance in 2006, PwC received £700.000 fees not related to audit from Northern Rock (House of Lords, 2010, 24).

[124] Audit related services include services such as reporting required by law or regulation to be provided by the auditor, reviews of interim financial information, and reporting on regulatory returns (APB Ethical Standard 5 (Revised), para. 54).

[125] To give an example, Enron's auditor Arthur Andersen received US$ 25 million for audit fees and US$ 27 million for non-audit fees in 2000. (Benston and Hartgraves, 2002).

we might see the actual results of these reforms in the EU audit market, possible effects of these reforms could be estimated in bold outline.

To begin with, it is acknowledged that the European Commission aimed to reduce the expectations gap by improving audit reports to provide more information to stakeholders and to the public. Expanding audit reports that include more information may indeed be helpful to the users of the audit reports in understanding the work of the auditor and the business of the audited entity. Hence, the expectations gap is likely to be reduced by the expanded content of public audit reports. Nevertheless, the long list of additional information to be included in audit reports (almost 38 provisions with nine clauses) create an extra regulatory burden on auditors and audit firms.

Secondly, the European Commission's proposal on the prohibition of provision of non-audit services has its remits because auditor dependency on non-audit fees is likely to impair auditor independence. However, the Commission's proposal for large audit firms to limit the provision of related non-audit services to the audit client is rather restrictive. These services are closely related to audit work and therefore are less likely to have a negative impact on independence. It is clear that the business of the large audit firms is likely to be affected by this restriction.

Thirdly, the policy options presented by the European Commission for the mandatory rotation of audit firms is expected to create a healthy competition environment. This policy will also increase the choice of auditors in the market, as mandatory rotation is likely to break up the barriers to mid-tier firms (European Commission Impact Assessment, 2011, p. 57).

Nevertheless, mandatory audit rotation is not unproblematic. Mandatory audit firm rotation results in significant costs because of a substantial amount of specific assets is destroyed and has to be rebuilt every time a rotation takes place.[126] For example, auditors have to have knowledge of the audited company's accounting system and internal control; the audited client must in turn make resources available for the audit (Arrunada and Paz-Ares, 1997, p. 34). The auditor as well as the audited client must rebuild these audit routines every time a rotation takes place, which is costly for both sides of the engagement.[127]

It can be concluded that there is no proof of a negative correlation between auditor continuity and the degree of auditor failure. However, there is also no empirical evidence that suggests that audit firm rotation will enhance competition in the market, but it is likely to increase audit costs. Thus, until now, regulators have focused on the rotation of key audit partners instead of audit firm rotation (Directive 2006/43/EC – as amended, Article 42). The mandatory rotation of audit firms may not be the best remedy for increasing competition, but it can be considered an effective tool in terms of preventing auditors from becoming overfamiliar with the audited company. Alternatively, voluntary rotation might be suggested. However, if the auditor resigns voluntarily, investors might consider this resignation a warning sign for the company and this would therefore not be a perfect alternative to mandatory rotation.

[126] It is estimated by PwC that switching costs for the audited company could be up to £1 million, while Office of Fair Trading (OFT) found the average of FTSE 100 audit fees was £5.2 million (OFT, 2011, para. 516).

[127] Also, it should be taken into account that many of these assets may not be rebuilt immediately, such as the trust that builds between two parties over the past successful audits (Arrunada and Paz-Ares, 1997, p. 45).

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