A Work Project, presented as part of the requirements for the Award of a Master Degree in Finance from the NOVA – School of Business and Economics.

Audit Reform: Impact on Markets

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A Project carried out on the Master Finance Program, under the supervision of:

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January 2018

Abstract

This Work Project will analyse the new Regulation issued about key matters of audit and also its impacts in the market. The key points being analysed are the mandatory rotation of audit firms and partners and the limitation of non-audit services. These will be studied through the vision of several agents of the markets. It will be briefly studied the impacts of this Regulation in Portugal (in terms of audit firms, fees, qualifications). This Regulation will solve some problems, such as the independence of the auditor, however there is not enough evidence that costs are being outweighed by the advantages.

Key Words: Audit, Mandatory Rotation, Audit Quality, Independence

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1. Introduction

In 2014, European Union approved the Regulation (EU) Number 537/2014 (it will be called "Regulation" in the rest of this Work Project), known as Audit Reform, about the rotation of the audit company due to the recent events of frauds. This work project will focus only in some articles of this Regulation, more specifically the requirement that a Public Interest Entity (PIE) changes the audit firm every ten years (with some exceptions), the rotation of key audit partners and it will also analyse, but in less detail, some restrictions of non-audit services. This Regulation has a huge impact in the markets, so it is important to understand the impacts in its agents and if this Regulation was in fact the best decision made to the markets. This Regulation was made in order to increase financial stability, since according to the Green Paper - "Audit Policy: Lessons from the Crisis" the previous rules could be improved.

Initially, it will be briefly clarified the role of audit in a firm and some concepts that are important to understand. Afterwards, the Regulation (Audit Reform) will be described and it will also be explained the reasons that made the European Union to implement it. European Union countries may adopt this Regulation or they can go further with the measures, so it will be briefly clarified the Regulation adopted in Portugal too. Finally, it will be studied the impact of this Regulation in the markets. It will be analysed the advantages and disadvantages to the market and it will be examined under three perspectives, the perspective of the audit companies (for the "Big four" and smaller companies), the perspective of the firms being audited and investors. The conclusion of this Work Project will be if this Regulation has in fact mores advantages than disadvantages to the market. This work project will take special attention in the new obligation of the rotation of the audit firm stated in the Audit Reform.

To do this Work Project it will be analysed several studies and it will be also analysed the Green Paper referred before as its answers published afterwards. The studies in analysis will be studies made to assess the impact on the market and studies that will help to understand that impact and the perspective of the agents of the market. By being working as auditor in KPMP, some interviews will be made with colleagues in this area, which will help to understand the true impact of this reform. The data used will be extracted from annual reports of the companies and the transparency report of the “Big Four”.

2. Literature Review

There were some studies made about this Regulation, especially about the mandatory rotation of the audit firms, which is the key subject of this Work Project.

In 2010, it was published by the European Commission a Green Paper - “Audit Policy: Lessons from the Crisis”, which launched a public consultation, in the perspective of a reform in the Regulation of the financial market due to the recent crisis. In 2011, the answers to this Green Paper were published and it was possible to understand what the agents of the market thought about it.

There are two studies, (Tagesson, Sjodahl, Collin, Olsson, & Svensson, 2006) and (Cameran, Trombetta, & Prencipe, Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Italian Setting), that studied the impact of the mandatory rotation of the audit firm in their countries, Sweden and Italy, respectively. In the study made with Sweden data, they found only weak reasons for the mandatory rotation. In Italy the mandatory rotation of the audit firm is in place for several years and they found some evidence of increase of audit quality in the end of the engagement, but it is not analysed if that increase of audit quality outweighs the disadvantages of this rule.

A study made with US data (Gipper, Hail, & Leuz, 2017) about partner rotation concluded that the rotation of the partner will not reduce audit quality. They also concluded that audit firm switches would cause much more disruptive effects than just only a partner rotation.

3. Role of Audit

Audit consists of reviewing someone else's work, in this case the financial statements of the company. In an audit, the company processes/controls also have to be tested. The auditor must have all the evidence documented when issuing an opinion about the financial statements.

Not all companies have to have an external audit of the financial statements. All listed companies must be audited. Sometimes, third parties may require an external audit, for example if the firm is asking for a loan, the bank may require an audit to the financial statements. In Portugal all "*Sociedades Anónimas* - SA" have to be audited. Some small companies may be exempt of being audited. This happens when the company meets two conditions out of the following on two consecutive reporting dates, which are: annual turnover must be less than 3.000.000€, assets worth less than 1.500.000€ and/or has no more than 50 employees (Crowe Horwath, 2014).

The role of an audit is to improve the confidence of the users of the financial statements. The auditor gives the opinion on whether the financial statements are materially correct and not an opinion about the financial health of the company. The auditor follows the International Standards on Auditing (ISA). ISA's only requires the auditor to have reasonable assurance; it requires enough audit evidence to decrease audit risk to a tolerable low level. Audit risk is the risk of expressing an incorrect audit opinion. The auditor is responsible for detecting material misstatements, but not responsible for detecting frauds.

Audit Risk (Jones, 2009) is composed by the detection risk (risk that the audit procedures do not identify material misstatements) and the risk of material misstatements. The risk of material misstatements is also composed by two risks, the inherent risk (inherent risk in the accounts, which is not controlled by auditors) and the control risk (risk that the controls used by the company being audited do not operate as intended, these controls are used to prevent or detect and correct misstatements).

The concept of materiality is quite important in audit procedures. According to ISA 320, "Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of the users taken on the basis of the financial statements" (IFAC). The value of materiality depends on the risk of the company and the value of the materiality influences the number of procedures to be done by the auditor.

There are three types of audit misstatements: factual (error, can clearly see the amount), projected (an error when using statistical sampling) and judgemental (differences from management and auditor judgements, auditor can have the opinion that the judgement made by the management is unreasonable). The difference between errors and frauds is that a fraud is an intentional act that involves the use of deception in order to obtain unjust/illegal advantages. There is the fraud triangle that represents what leads someone to commit fraud. In this triangle it is represented the opportunity, the incentives/pressure and attitude/rationalization. There are two types of frauds: misappropriation of an asset or manipulation of the financial statements.

The responsibilities of the auditor are to remain independent (audit reform focus on this matter), be sceptical, apply professional judgement, respect confidentiality and conduct audits according to the relevant framework. The auditor has to be independent in mind and in appearance, which means that the state of mind of the auditor allows the expression of a conclusion without compromising professional judgement, so that the auditor acts with integrity and exercises objectivity and professional scepticism.

4. Green Paper – "Audit Policy – Lessons from the Crisis"

In 2010, it was published by the Commission a Green Paper entitled "Audit Policy: Lessons from the Crisis" (European Commission, 2010), which launched a public consultation, in the perspective of financial market regulatory reform (role and scope of audit and how the function could be improved). Due to the crisis it was important to increase financial stability (European Parliament and Council, 2014). In 2011, the answers to this Green Paper were published (European Commission, 2011).

On point 3, it is analysed the governance and independence of audit firms. On this point, it is questioned if the mandatory rotation of audit firms should be considered even when the key audit partner changes, which already happens in accordance to the Directive 2006/43/EC. A study made in 2006, 33% of the respondent companies reported that their auditor has served the company for more than ten years (London Economics and Prof. Ralf Ewert, 2006), so it is possible to see that the rotation of the audit firm would have huge impacts in the market. On this point, it is also stated the wish of reinforcing the prohibition of non-audit services by the audit firms and to limit the proportion of fees an audit firm can receive of non-audit services (possibility of creation of "pure audit firms", which did not happen).

On point 5, it is analysed the concentration and market structure. The market is highly concentrated in the "Big Four" audit firms, a study made in 2006 stated that approximately 90% of the auditors for large companies (EU25) were the "Big Four" (London Economics and Prof. Ralf Ewert, 2006). This concentration in the market might cause systemic risk. To avoid this, the Commission in considering the following measures: joint audits/audit consortia (two different audit firms, one of them cannot be one of the "Big four", who share the audit work), mandatory rotation of auditors. Most of the agents believe that in fact if one of the "Big Four" fails, it could exist a momentary disturbance in the market that could weaken the financial stability, but it would not cause an economic crisis. So, the agents of the market believe that there is a risk, but some (the “Big Four” and Investors) think that it should not be considered as systemic risk. Saying this, there is different opinions about the audit consortia, the “Big Four” believe that it would be negative for the market due to problems of co-ordination on the other hand smaller audit firms support this idea.

With this public consultation it was possible to conclude that the previous rules could be improved, what lead to this new Regulation, known as Audit Reform. In spite, of some of the points analysed being in general disapproved by the market (as mandatory audit firm rotation), the rule went forward, so it is important to take special attention on the impact of it and why they decided, that in spite of this general opinion, it would be better for the market to have this rule (answers to point 3 of this Green Paper will be analysed in more detail on point 6 of this Work Project).

5. Audit Reform

5.1. Objectives of the Regulation

The main objective of this Regulation is to guarantee the independence of the auditors, to eliminate conflict of interests that may arise due to an excessive familiarity between the auditors and the management group of the company being audited. Another objective of this reform is to contribute to a more dynamic audit market, since the market is dominated by the “Big Four” (which clearly happens in Portugal, since only one of the companies of the PSI 20 is not audited by the “Big Four” – Graph 1), which might be considered as systemic risk (European Commission, 2016). This began to be a key issue after the financial crisis of 2008, when investors no longer trusted in the financial statements of the companies, since they had doubts about the independence of its auditors. One big scandal in 2008 that contributed to this insecurity was the involvement of an audit firm in the Lehman Brothers fraud. Lehman Brothers hid over $50 billion in loans masked as sales (Accounting Degree, s.d.). The audit firm was accused of helping Lehman Brothers of making investors believe that Lehman Brothers was in a stronger financial condition (Scannell, 2010).

The main objective of this reform is to improve audit quality and to increase investors' confidence in financial statements, which is crucial for economic development.

5.2. Legal Framework

The Regulation (EU) Number 537/2014 instructs on the organisation and selection of audit firms by Public Interest Entities in order to avoid conflict of interests and in order to promote the independence of the auditors (European Parliament and Council, 2014).

The definition of EU Public Interest Entities (PIE's) is in the Directive 2014/56/EU in Article 2, paragraph 13. Public Interest Entities are entities whose securities are admitted to trading on a regulated market of a Member State, credit institutions, insurance undertakings or entities designated as PIE by Member States, for example if the entity is relevant as a result of its size or the nature of its business (European Parliament and Council, 2014).

The rules of prohibited non-audit services are described in Article 5. According to the Article 5, paragraph 1, of the Regulation stated above, the following non-audit services are forbidden to be realized simultaneously as audit services: some tax services (such as preparation of tax forms, payroll tax, etc.); being part in the management or decision-making of the Public Interest Entity; bookkeeping and preparation of accounting records and financial statements; payroll; design and implementation of internal controls or risk management processes; valuation; legal services; services linked to internal audit function, financing, capital structure and investment approach; dealing in or underwriting shares; human resources; structuring the design and cost control. For the permitted non-audit services, on Article 4, paragraph 2, it is stated that the total fees of these services cannot exceed 70% of the average of fees paid in the last three sequential financial years.

On paragraph 7, of Article 17, it is explained the rotation of the key audit partners. The definition of key audit partners is stated in the Directive 2006/43/EU in Article 2, paragraph 16, and it says that the key audit partner is mainly responsible for the audit on behalf of the audit firm and who signs the audit report (European Parliament and Council, 2006). The key audit partners can only take part in the audit for a maximum of seven years (which continues to be the same amount of time compared to the previous Regulation), and should not be part of the engagement for three years (before this Regulation, it was only two years). The Member State has the option to require that the key audit partner terminates the participation in the audit before the seven years stated before.

The rules about the rotation of the audit firm is in Article 17. According to Article 17, paragraph 1, of this Regulation, the initial engagement should be at least one year and it can be renewed, but the engagements of the audit firm cannot exceed a duration of ten years. On paragraph 6, it is stated that the Public Interest Entity may ask, on an extraordinary basis, an extension of the duration of the engagement of the audit firm, in the case that it meets one of the criteria of paragraph 4, of this article, which are: it may be possible to extended to 20 years, if the selection of statutory audit firms is in agreement to article 16 of this Regulation (from paragraph 2 to 5), or it can be extended to 24 years, if more than one audit firm is simultaneously involved (so there is a joint audit report as referred to in Article 28 of Directive 2006/43/EC). On paragraph 3, of this article, it is stated that neither the audit firm, nor any members of their network (where applicable) can participate in the statutory audit of that Public Interest Entities within the subsequent four years. On paragraph 8, it is explained how the duration of the engagement should be calculated. It should be calculated from the first financial year enclosed in the engagement letter in which the audit firm has been selected for the first time for the carrying-out of consecutive statutory audit for the same Public

Interest Entity. The rotation should be gradual in accordance to the complexity of the activity of the Public Interest Entity in question.

On Article 42, it is stated that Member States must take on appropriate provisions to guarantee the effective use of this Regulation. The Member State may follow this Regulation strictly or can go further with these measures.

There are other topics in this Regulation and some of them are: how an audit report should be done, transparency report of the audit firms, the role of audit committee and competent authorities, but since these are not as important to the scope of this Work Project, they will not be analysed.

5.3. Audit Reform in Portugal

In Portugal, this Regulation was finished on 9th September 2015 and come into force on 1st January 2016. The Portuguese law has two main pieces: Law 140/2015 (which is the key legal tool from which it was transposed the EU audit reform) and Law 148/2015 (supervision of the audit profession) (KPMG, 2015).

In the Portuguese Law 148/2015, Article 3, it is defined Public Interest Entities according to what is stipulated by the European Union, and the entities nominated as Public Interest Entities by Portugal are the ones stipulated in the Directive and the companies that have for at least two consecutive years, total liquid assets over €300.000.000 or business volume over €50.000.000 (Lei No 148/2015, 2015).

The Portuguese Law 140/2015, Article 54, point 3, establishes that the audit firm must be at least two years for Public Interest Entities and a maximum of eight to nine years, and according to point 6, cannot be the audit firm for the next four years. On point 4, it is established that can be possible to prolong to ten years if approved by the National Audit Oversight Board. So, it is not allowed tender or joint audit extension until 24 years, so it is more strict that the European Law. According to Article 54, point 2 of Law 140/2015, key audit partners will also have to rotate after a maximum of seven years and cannot be nominated again for the next three years. According to the Article 77, point 1, only allows a maximum fee of 30% of permitted non-audit services. On point 8, it is described the non-audit services that audit firms cannot give when they are the audit firm of the Public Interest Entities, which are the same services that are not allowed in the Regulation 537/2014 (Lei n.º 140/2015 - Estatuto da ordem dos revisores oficiais de contas, 2015).

6. Impact in the markets

It is important to understand the impact in the markets, if in the overall there are more advantages than disadvantages. In spite of the Regulation being already implemented, it can still be possible to change this Regulation (even if only in part), if in fact it is not beneficial for the market, so it will be analysed the advantages and disadvantages to the market and the perspectives of the agents of this market.

6.1. Advantages

The main advantage of this Regulation is that it will ensure independence, so it will restore investors' confidence in the market which is good to the economy.

With the rotation of the audit firm, auditors will not be as familiarized. If an audit firm is auditing a company for several decades, auditors may create a relationship with the employees, which can influence their judgement, they may not be as sceptical as they should and so they might not detect fraud. So, in that sense it is an advantage, it will ensure that auditors will not be so comfortable that they would lose their independence and scepticism. Besides that, if an audit firm carries services for a long time, they might be doing the same procedures each years and not considering areas that in the past were right but in the present might be wrong, so a change of the audit firm would bring to the company new approaches

(Cameran, Negri, & Pettinicchio, The audit mandatory rotation rule: the state of the art, 2015). With the rotation of firms, audit firms know that the next audit firm will see their work, so they will be careful in order to not destroy their reputation (Tagesson, Sjodahl, Collin, Olsson, & Svensson, 2006).

The limitations of non-audit services will also limit auditors to be biased or have conflict of interests, since with the non-audit services the firm would be earning a lot of extra money. One example is the case of Enron, the audit firm was earning a lot of money with other services, which might have influenced its audit report (Vale). This case also affected the confidence of investors, so this Regulation would solve these type of problems.

6.2. Disadvantages

As audit firms get familiarized with an organization (which might take a couple of years), auditors will know what to ask in order to detect frauds in the company, so auditors are more effective. With the obligation of rotation, initially, the new auditors will not be familiar with the organization and due to that, they might not detect a fraud (Guest, 2015). In addition, the mandatory rotation will increase costs to the audit firms without certainty that in fact the audit quality will increase. A study made by SDA Bocconi shows that the audit firm gains knowledge, so audit quality increases, after three years, and also after six years, which means that in the first years is when the audit quality is lower, therefore this mandatory rotation may create lower audit quality, which is the opposite of what is wanted (SDA Bocconi, 2002).

As referred above, the costs will increase, not only for the audit firm, but for the Public Interest Entity too. Both will have higher costs in terms of time, since the new auditor will have to understand the business, which is only possible with the time of the employees of the Public Interest Entity. Since audit firms are also incurring in more costs in order to understand the business, they will have to charge a higher price to the Public interest Entity. It can also be considered a “cost” the risk of an audit failure/low quality audit. All this extra costs incurred without being complete sure that the independence and audit quality will indeed increase, and if they do if that benefit will outweigh the costs incurred.

One objective of this reform is to decrease market concentration, but in fact, with the mandatory firm rotation, it can even reduce competition, since Public Interest Entities would not be able to choose that same firm, that could be the best audit firm for that Public interest Entities, and since companies tend to elect one of the “Big Four” (smaller firms tend to have lower quality level in Public Interest Entities (Naess-Schmidt, Thelle, & Westergaard-Kabelmann, 2012)) it would not decrease concentration. This also brings another disadvantage, which is the Public Interest Entities cannot choose the firm that they think it is the best, so it is limiting their freedom of choice, therefore it is taking some capacities to the audit committee.

According to the answers on the Green Paper – “Audit Policy: Lessons from the Crisis” on point 5.3, Public Authorities do not support the obligation of rotation of the audit firm. There was one recommendation to this rule, that in spite of being a strict rule, the audit committee could decide if the firm thinks it is best to rotate audit firms. Public Authorities also think that this would increase costs and reduce audit quality. Public Authorities even answered that in order to organise acquisition of clients, the possibility of collusion between audit firms could increase, and if that in fact happens and the “Big Four” are part of that scheme, then the market concentration would be even higher.

When there is a change of audit firms, stakeholders may take special attention if the intention was to “buy” another opinion that they wished, but with a mandatory rotation, it will be harder to infer if it was a change due to a law or if it was a voluntary change with an interest behind. This can be called as the information cost and it is analysed in the article of the Journal of Financial Perspectives and EY Global Financial Services Institute (Cameran, Negri, & Pettinicchio, The audit mandatory rotation rule: the state of the art, 2015).

The non-audit services might increase the auditor's knowledge of the Public Interest Entity, which increases audit quality, so, if some of these services are prohibited, the audit quality may decrease. The idea of creating pure audit firms is not well seen, since it would cause loss of knowledge and consequently, decrease audit quality, so it was not implemented since the objective was to increase audit quality and not decrease it.

6.3. Perspective of Audit Companies

6.3.1. "Big Four"

The "Big Four" companies in audit are: KPMG, Ernst & Young (EY), Deloitte and PricewaterhouseCoopers (PWC).

According to the answers on the Green Paper – "Audit Policy: Lessons from the Crisis" on point 3.2, the "Big Four" oppose to this obligation of rotate the audit firm, since there are studies (as referred above) that this rotation will harm the audit quality.

In an article published by The Journal of Financial Perspectives with EY Global Financial Services Institute, it was spoken about countries that had implemented the mandatory rotation and years later removed it. One of these cases was Canada. Canada implemented this rule in 1923 until 1991. Canada decided to remove this rule because the costs were much higher than the benefits that this rule brought. These experiences may alert that this rule, in fact, it is not the best for the market (Cameran, Negri, & Pettinicchio, 2015).

A report published by Copenhagen Economics, analysis the revenues of the "Big Four" in UK, 2011. It is possible to see that approximately 60% of their revenues are from non-audit services to non-audit clients. The percentage of non-audit services to audit clients is small, between 9% to 17%. The “Big Four” have a huge reputation to defend. Errors made with audit clients might have a huge impact in their reputation. Considering that more than half of their revenues are from non-audit clients, the incentive to not being independent is low, since they would have a lot to lose (Naess-Schmidt, Thelle, & Westergaard-Kabelmann, 2012).

An article made by KPMG, states that mandatory rotation will not allow the audit committee to choose the firm that they think is most skilled, which can decrease audit quality (KPMG, 2011). Some parameters that are important to the Public Interest Entities are if the audit firm has the know-how of a particular area, the geographical coverage of the firm, its network, the size of audit teams and of course the audit fees (European Commission, 2011). So it is important to have all the options available in order to choose the most capable firm.

On point 3.3 and 3.4 of the Green Paper, the “Big Four” oppose to the strict prohibition on non-audit services, but appreciate the restriction of non-audit services. They support the existence of a limit on the fees from non-audit services.

PWC even suggests that the restriction of non-audit services is a measure that should be made in order to increase independence of the audit firms. They suggested this measure instead of the mandatory rotation (PWC, 2013).

6.3.2. Smaller audit companies

According to the answers on the Green Paper – “Audit Policy: Lessons from the Crisis” on point 3.2, smaller audit firms do not also agree on this mandatory rotation, since rotation may not solve the market concentration problem and it would increase costs.

For Mid-size firms, the mandatory rotation may create new opportunities to them to enter in the market of Public Interest Entities, but for small firms, if they had a PIE, they will lose it and it will be hard for them to gain another one (European Commission, 2011).

On point 3.3 and 3.4 of the Green Paper, smaller audit firms believe that the restriction of non-audit services is an important measure to guarantee the independence of the audit firm.

6.3.3. Interviews to Auditors

Some interviews were conducted with auditors from KPMG, the firm where I have been working since September, in order to understand their view of this reform. They were inquired about their opinion: on the mandatory rotation of the audit firm; the advantages and disadvantages to the market; if this Reform will help to improve audit quality and in consequence if it will help to discover more frauds; and if there was a change in the behaviour of auditors since this reform started in Portugal, in 2016.

All the interviewees answered that audit quality will be harmed due to the loss of company background. One interviewee answered that "In fact, there is one big advantage that is usually talked about, which is the fresh-look that new auditors will have". Overall, auditors tend to believe that it might be good to independence but they believe that there is a big disadvantage with the mandatory audit firm rotation, which is that the new auditors will not have the knowledge/company background that was previously acquired, which can decrease the audit quality and consequently the new auditors may not detect problems/fraud. The auditors think that there was not a change in the behaviour due to this reform. One interviewee said "Before this reform, after the recent scandals, there was in fact a change in the behaviour, which is the increase of the importance of risk management in audit firms, but not after this reform". It is normal that auditors believe that they were doing everything right, so they do not consider that there is the need to change their behaviour due to this reform, nonetheless they felt the need to give more importance to risk management after the scandals.

6.4. Perspective of Public Interest Entities

If the costs of the audit firms increase, indirectly Public Interest Entities will pay this cost, since audit firms in order to compensate this cost may increase their price. In this sense it is bad for the Public Interest Entity, thus, it is only beneficial for the PIE if the audit quality increases in order to compensate the increase in cost that they will face (European Commission, 2011).

According to the answers on the Green Paper – “Audit Policy: Lessons from the Crisis” on point 3.3 and 3.4, Public Interest Entities do not support the prohibition of non-audit services, since they think that the diversity of skills of the firms increases audit quality.

On point 5.2 of the Green Paper, which is discussed in order to decrease market concentration of the “Big Four”, Public Interest Entities believe that there are some advantages of having joint audits (“Big Four” and non “Big Four”), but the costs outweigh those advantages, since costs would increase between 15% to 20%.

On point 5.3 of the Green Paper, the majority of Public Interest Entities do not support mandatory rotation of the audit firm.

6.5. Perspective of Investors

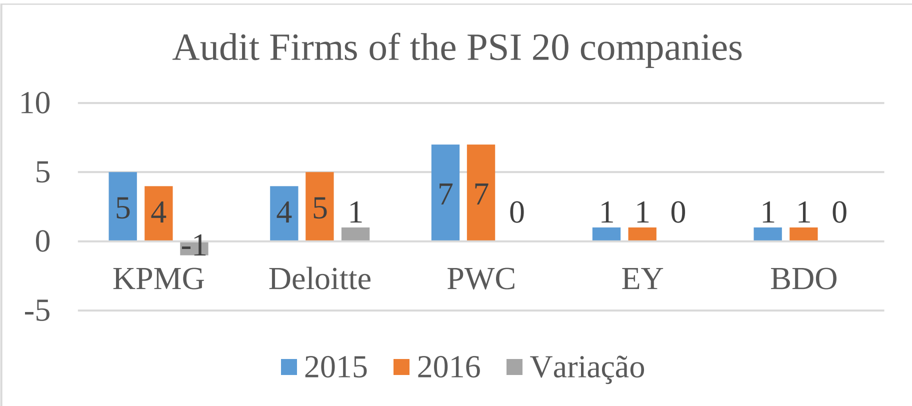
According to the answers on the Green Paper – “Audit Policy: Lessons from the Crisis” on point 3.2, there are divergent opinions between investors in respect to the mandatory rotation. If, the audit quality increases, it is a benefit for investors.

On point 3.3 and 3.4 of the Green Paper, Investors believe that in fact audit firms should not give non-audit services that are not related to the audit and that the non-audit services should be better disclose. Investors suggested a list of the non-audit services that are allowed and which are not (which now exists in the Article 5 of the Regulation 537/2014).

6.6. Current Impact in Portugal

Considering the PSI 20 Index in Portugal (The list of PSI 20 companies was extracted from Euronext as of 27/10/2017, which are: ALTRI, BCP, Corticeira Amorim, CTT, EDP, EDP Renováveis, Galp, IBERSOL, Jerónimo Martins, Mota-Engil, NOS, NOVABASE, PHAROL, REN, SEMAPA, SONAE, SONAE Capital and The Navigator Company), it is possible to analyse the immediate impact of this Regulation in 2016.

As it is possible to perceive through the graph bellow (Graph 1), in 2016, only one company from the PSI 20 changed the audit firm (which was BCP), so the immediate impact was not big. It is possible to infer that probably this Regulation will not solve the problem of the concentration of the market of the "Big Four", since BCP changed from KPMG to Deloitte, so in 2016 there is still only one firm in PSI 20 that does not have as audit firm one of the "Big Four".

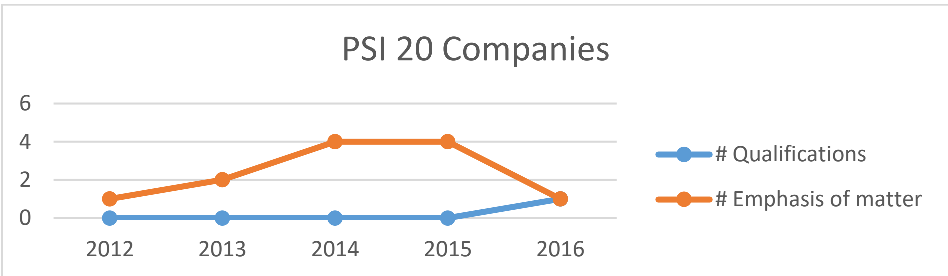


Graph 1: Audit firm of PSI 20 companies, Source: information extracted from annual reports of the PSI 20 companies.

It is also known that Santander, which is a Public Interest Entity, changed its statutory audit firm, from Deloitte to PWC (Alves, 2017). SEMAPA that had PWC as auditor will now change to KPMG or to Deloitte, so this Regulation is not being able to change the market concentration (Lusa, 2017).

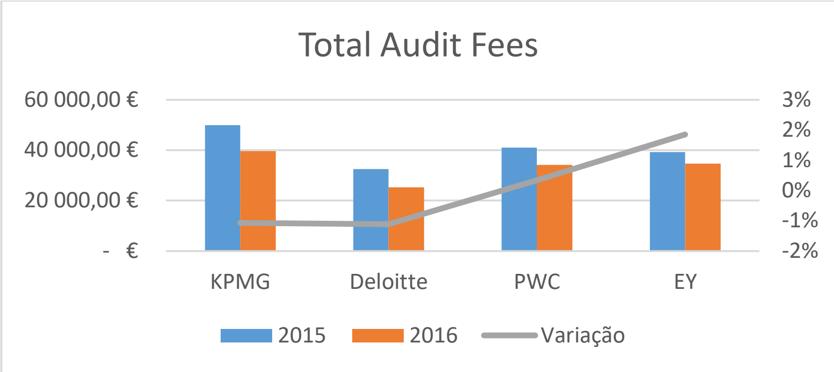
In order to analyse if this Regulation had an impact on the audits, it was analysed the number of qualifications and emphasis of matter issued from 2012 to 2016 (year of beginning of the implementation of the Regulation) in the PSI 20 Companies. An emphasis of matter exists to capture the attention to a specific topic, a qualification is worse than an emphasis of matter. It is not possible to infer more precisely the impact in the independence of the firms in Portugal, since the Regulation is quite recent.

The graph bellow (Graph 2) shows, the number of qualifications and emphasis of matter. It is possible to infer that in fact, there was an increase in the number of qualifications, but it is not possible to know if it was a coincidence, since it was only an increase of one qualification. However, by comparing five years, it is possible to see that this was the only qualification, which can say that audit firms are being more careful. By analysing previous annual reports, it is possible to see that Pharol was having several emphasis of matter (since 2013) and in 2016 the quantity of emphasis of matter decreased but the audit firm put a qualification in the accounts of the company, which might indicate that the audit firm was more careful that year.



Graph 2: Number of Qualifications and emphasis of matter of the PSI 20 Companies, Source: information extracted from annual reports of the PSI 20 companies.

By analysing the transparency reports of the “Big Four” in 2015 and 2016, it is possible to infer through the graph bellow (Graph 3) that the market in the overall is worse, the fees decreased. It is also possible to see that in comparison KPMG and Deloitte were the ones that suffer more, since in audit they are the biggest ones in Portugal, so they had big clients that were lost due to this Regulation, as the example of BCP to KPMG.



Graph 3: Audit fees from 2015 and 2016, Source: extracted from the transparency reports of the audit firms.

7. Conclusion

The Audit Reform is a recent matter in the audit firms since it will change their business model. Audit firms will no longer have Public Interest Entities that could be seen as a client for life, especially the "Big Four" that will now have to be better at negotiations with the entities in order to compensate the ones that will lose as clients due to this reform.

It is important to study the impact of this reform in the market, because there can be advantages, but it is still questionable if these advantages outweigh the costs. These type of measures were already implemented in some countries and in some cases these were abolished since it was possible to understand that it was not as beneficial as it was thought.

There are several points in this reform, so it is important to understand if all of them, actually make sense or if there should be some corrections. After studying the theoretical impacts of several points of this reform, it is possible to conclude that some are in fact beneficial, but others that its benefits may not be sufficient to compensate the costs to the market. The best measures that should indeed be implemented are the rotation of the key audit partner and the implementation of restrictions of non-audit services, it is in the opinion of most of the agents of the market that these will have more benefits than the costs that will occur. In the opposite spectrum, most of the agents of the market believe that mandatory audit rotation is not beneficial for the market due to the costs that would occur.

Since this Regulation is quite recent in Portugal, it is not possible to infer with certainty that these measures will increase audit quality and independence of auditors. There is evidence of one qualification which did not happen for a long time, which can say that the Regulation has impact, but it is still not possible to say that these benefits outweigh the costs.

In conclusion there is lack of evidence to support that mandatory rotation increases auditor's independence and audit quality and that these benefits outweigh the costs. There are points of the Regulation that make sense to implement such as partner rotation and limitation of non-audit services, but the mandatory audit rotation does not seem as reasonable due to the costs that the market will have to incur.

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