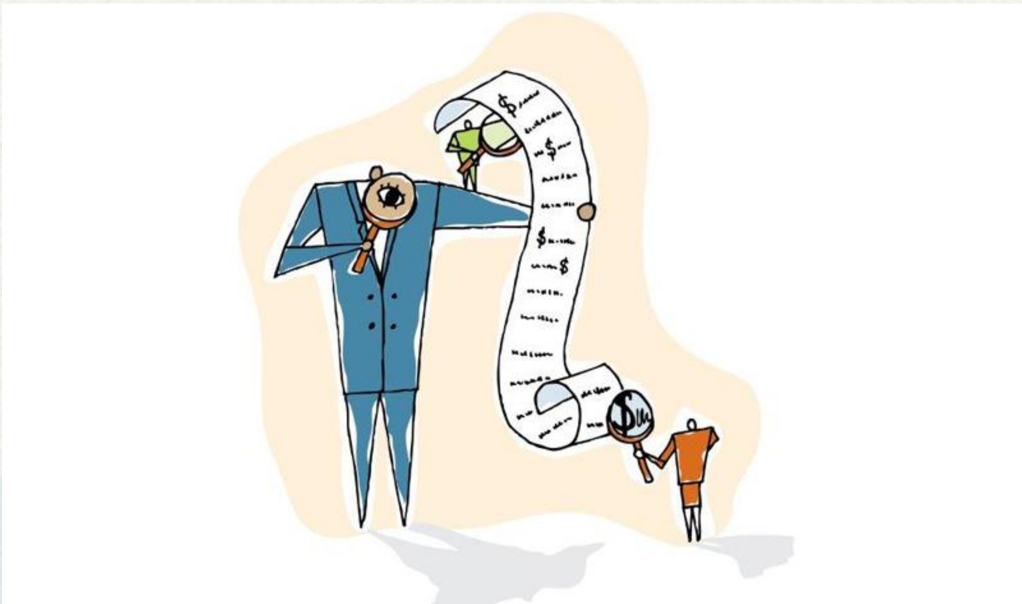
Auditors Independence

How the current framework cover the threat to auditor's independence in the EU



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Executive Summary

Revisor uafhængighed er en af de centrale faktorer der påvirker revisionsbranchen på grund af den værdi en revisionsrapport indeholder til aktionærer, kreditorer og andre interessenter. Mange hævder, at det faktisk er det vigtigste princip i revisionen, da mange interessenter er afhængige af den opfattelse som disse revisorer giver. Revisorernes mening er derfor meget afgørende og lovgiverne bør være meget forsigtige med at holde denne proces så retfærdig som muligt.

Denne afhandling skal søge at fastslå hvorvidt forskellige ikke-revisionsydelser påvirker uafhængigheden og objektiviteten hos de eksterne revisorer, der arbejder i revisionsmiljøet. Den grundlæggende problemstilling er "hvorvidt den nuværende lovgivning dækker truslen mod revisors uafhængighed?"

Denne afhandling vil anvende kvalitativ analysemetode, fordi rammerne for tilgangen er i overensstemmelse med målene for denne afhandling. Der er sæt fokus på videnskabelige artikler og litteratur gennemgang af information fra tidligere forskere for at etablere den aktuelle tilstand af dette felt. Som nævnt før, kan manglende revisors uafhængighed have vidtrækkende konsekvenser, derfor kan revisorer ikke gå på kompromis med uafhængighed.

Begrænsningerne i denne afhandling er først og fremmest, at direktiverne udstedt af EU-Kommissionen ikke overvejes. Derudover fokuserer denne afhandling kun på reglerne i EU. Selv om nogle af skandalerne fandt sted i Amerika, er GAAP ikke diskuteret. I EU er der ikke noget specifikt land involveret men afhandlingen analyseres lovene generelt.

EU-lovgivningen blev vedtaget i 2014. Formålet med denne lovgivning var at forbedre markedet for lovpligtig revision. I denne afhandling er der lagt vægt på de tre love, som direkte påvirker revisors uafhængighed; gebyr på ikke-revisionsydelser, obligatorisk rotation og forbud mod nogle særlige ikke-revisionsydelser.

Meninger fra Big 4, mindre revisionsfirmaer, investorer og akademikere der offentliggøres som svar på den grønne bog, diskuteres også. Desuden diskuteres fordele og ulemper

ved alle tre begrænsninger, og derefter analyseres de med de tidligere revisions skandaler.

For gebyrer og forbud mod nogle ikke-revisionsydelser er analysen baseret på de berømte Enron scandal, WorldCom og en nyere Carillion-skandale. Det konkluderes, at begrænsningen gælder i disse tre tilfælde og kunne have hjulpet med at få et bedre resultat, hvis de var blevet anvendt rettidigt.

Til obligatorisk rotation er analysen baseret på Parmalat-skandalen. Selv i dette tilfælde konkluderes det, at begrænsningen ville have bidraget til at få et bedre resultat.

I konklusionen at opsummere hele afhandlingen og veje fordele og ulemper samt analyser med hensyn til de tidligere skandaler, er det oplysende, at EU-Kommissionen har taget det rigtige skridt i retning af et bedre revisionsmarked i fremtiden.

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1.0 Introduction

1.1 Introduction

Auditor independence is one of the core factors that influence the audit profession because of the value an audit report holds to shareholders and stakeholders. Many argue that it is actually the most important principle in auditing since the accuracy of the opinion they produce can be influenced greatly by both the mental and professional independence maintained by the auditor throughout the process. With the advancements in technology, the audit profession has too evolved and so have audit procedures.

Though a company's progress is often measured in financial terms, increasing wealth is of diminished value unless all the stakeholders can be incorporated in the sharing of the piece. Auditing is a very important key in uplifting financial growth of any company, with transparency being among important gauges of development. Auditing is a requirement that demands corporate to have an open and transparent means of accounting and day to day operations (Halim, A. and Sutrisno & Achsin, M, 66).
As also stated by Soh and Martinov, for the auditors to perform their task objectively the auditors need to be free on any influence by the involved parties and thus arises auditors independence (Soh & Martinov-Bennie, 2011), which is also the problem area for this research.

However, the challenge of auditor independence is one that technology cannot solve entirely. Failure to maintain independence is caused by several personal and external factors including existing relationships with the client and protecting personal interests.
As seen in several financial scandals, lack of auditor independence has damaging effects that have brought down several corporates and it is therefore important for auditors to maintain professional ethics in their work. In the wake of these scandals, it is necessary that research be carried out into the field to try to establish the best ways to mitigate the threats to auditor independence (Piskar, 2005).

1.2 Problem statement

Auditor independence is an important aspect in finance that cannot be overlooked and therefore clear and definitive frameworks need to be established by governments to protect shareholders and give guidelines to auditors regarding the ethics of their profession. There is also a need for introduction of measures to mitigate threat to auditor independence. This research delves into the audit field, its history, current practices and developments. It will also identify the threats to auditors' independence. It will also establish the current European laws regarding auditor independence; make case studies of instances where auditor independence has failed, the risks associated and the effect it has on the involved parties.

The study shall also seek to ascertain the pervasiveness with which different non-audit services undermine the independence and objectivity of the external auditors working in the auditing environment. The fundamental research question is *"how the current framework cover the threats to auditor's independence?"*

The questions will be answered by accomplishing the following research objectives:

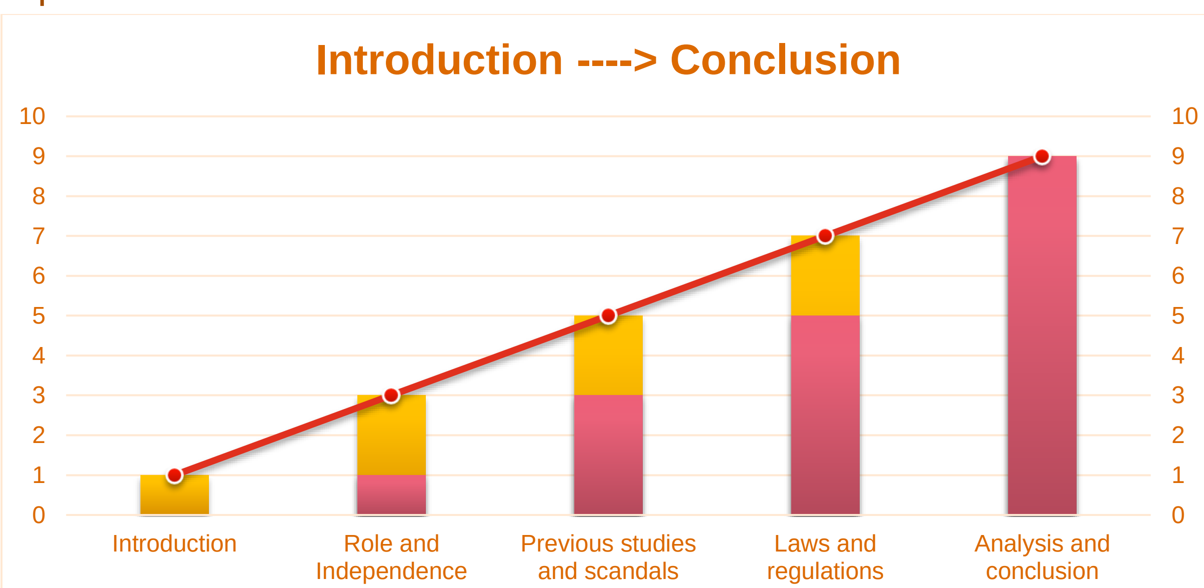
- To identify the factors / non-audit services that pose a threat to auditor objectivity
- To consider the current laws there are for protecting against such risks.
- To look at the previous failures of auditor's independence and see what affect it had on the corporate world as well as the whole accounting profession.
- To recommend ways through which the threats to auditor objectivity can be mitigated to an acceptable level

1.3Methodology

This research will use qualitative analysis methodology because the framework of the approach is in line with the goals of this research. Qualitative analysis helps the researcher gain a better understanding of the field they are exploring and get a broad perspective of the field. The main aim of this research is to study the audit profession and the role of auditor independence in the practice and therefore qualitative analysis will be effective in gathering the necessary information. There exists a huge variety of information regarding auditor independence by scholars, experts and people of interest in the public domain thereby providing a huge data pool for the researcher. This research will focus on scholarly articles and literature review of information from past researchers to establish the current state of this field.

Further, the paper will review several case studies that have been widely reported for failing to adhere to independence of the auditor. As evidenced by the case studies in this thesis and many more scandals that have hit different companies, failure of auditor independence can have far-reaching consequences. These consequences can span across financial and legal grounds and therefore auditors cannot compromise on it. Lack of independence may also damage the reputation of an audit firm and may go further to contribute to its collapse, as was the case of Arthur Andersen. Auditor independence is crucial from an investment point of view as audit reports play a significant to lenders and investors and therefore audit reports should be credible. This practice also influences stock markets and economic growth and therefore governments should ensure controls are put in place to guide the profession. (Krishnamoorthy, et al., 2017). As a result of this, case studies of the two companies will be instrumental in completing the research concerning auditor's independence.

1.4Structure



1.5 Limitations

The EU Commission issued a Green book in 2010, a Directive in 2014 and the final regulation in 2014. In this research, there will only be focus on the Green book and the final regulation. The Directives have not been used as most of the laws are applied in the regulation, which might make it repetitive. The Directive is briefly described but the changes in the 2006 and 2014 Directives are not covered. The Directive of 2006 will not be looked at.

Apart from that, there will only be focus on the matters that relate to independence directly such as audit fees, firm rotation and non-audit services. Furthermore, the focus in this thesis will be on the EU and specifically the laws in Europe whereas the American law GAAP will not be discussed. There are examples of accounting scandals that happened in the US but these will be analysed in respect to the European laws. No specific country will be used in this research as Member states might differ in some laws but in this thesis, it will be looked at generally. Some examples of the UK are taken, where some of the local situations have been used.

The analysis is also widely based on the big four and in some cases the big six in the UK. The big four being Deloitte, PwC, EY and KPMG whereas the big six adds Grant Thornton and BDO. The smaller firms have not been used that much in this thesis as the rules float around PIE's and generally it is these big firms that audit them. However, in the scandals section different corporations across the world are analysed. Again, the laws are not analysed with the accounting scandal in respect to the local laws but they are analysed by looking at regulation generally.

2.0 Auditor

2.1 Auditing and Auditors

i. Auditing

An audit involve a critical examination of records and documents within an organization to establish if internal practices are in compliance to the set regulations and may be performed on a product, processes within the organization or the whole system. Audits may also be carried out in order to attain accreditation or certifications, check the performance of an organization or as a follow up to check if preventive actions put in place have helped and if corrective measures recommended were effectively established. There are two ways to classify audits; as internal audits or as external audits. In an internal audit, employees of an organization measure its performance against the standards set, but the auditors hold no interests in the results of the audit process to enforce independence (Fraser & Pong, 2009). Customers, suppliers or an audit firm that have no relationship with the organization carry out external audits. The audit process involves:

i. Scheduling meeting

The organization intending being audited agrees with the auditor on when to conduct a meeting with all parties involved in the audit process. This allows them to prepare any necessary documents and the scope of the investigations into the finance books.

ii. Fieldwork

The auditor implements the audit plan through questioning staff members and analysing procedures and documents provided for the audit. They check how internal controls and practices comply with the regulations set by the governing body.

iii. Report

After completing the review process, the auditor compiles a report incorporating their findings, any corrective measures needing to be taken and preventive measures the organization can implement.

iv. Follow up

This is carried out to evaluate if recommendations made during a previous audit have been implemented effectively. The organization audited and the auditor usually agree the time of the follow up audit.

ii. Auditing and accounting

Auditing is usually is mixed up with accounting by the general public. They get confused as auditors mostly know a lot of accounting matters. Another reason for confusion is that auditors use accounting information in order to audit. To strengthen the confusion, once auditors are certified they get titles such as Chartered Accountant or in US, Certified public accountant. (Arens et al., 2000)

"Accounting is the recording, classifying and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making"

Basically the aim of accounting is provide information to the management or any other users of a company to make crucial decisions. However, people with such information, accountants, must have thorough understanding of the laws and regulations that are required for preparing accounting information. Some of the roles of accountants, is to make sure a company's financial activities are recorded timely and systematically. Such information is to be prepared properly and within the parameters of the respective laws (Arens et al., 2000).

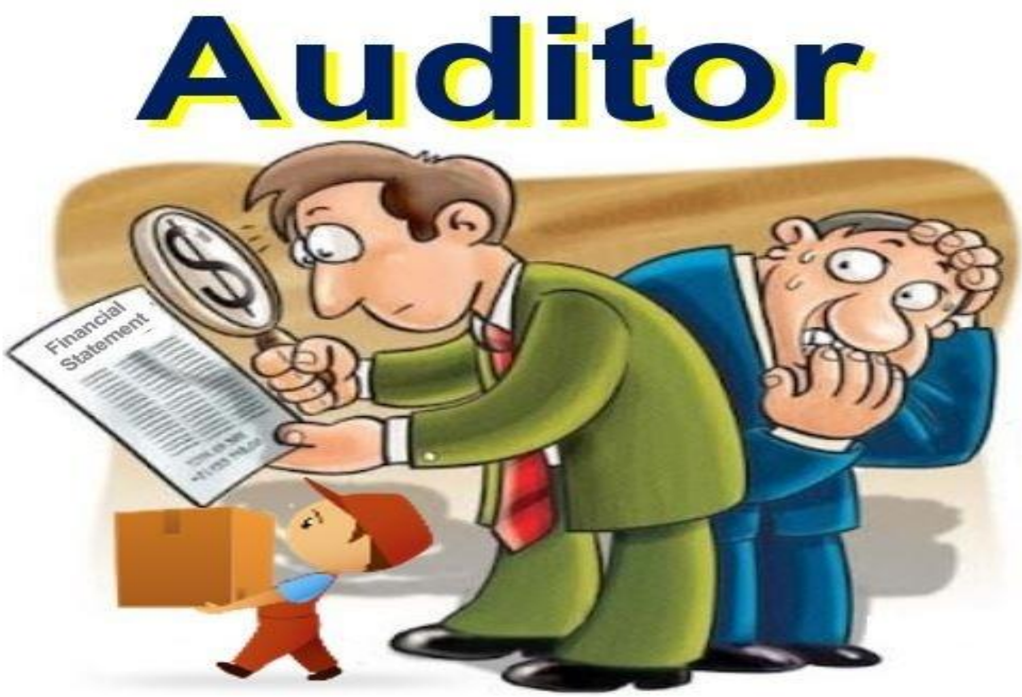
Auditing can be said to be the next part of accounting, basically the information prepared by accountants is verified by auditors.

"In auditing accounting data, the concern is with determining whether recorded information properly reflects the economic events that occurred during the accountin period."

As stated above, an accountant must have thorough understanding of the laws for preparing information, so in order for an auditor to check such information, the auditors also needs to have a thorough understanding of the laws. Apart from these laws, auditors must also excel in interpretation of audit evidence. This is one of the main expertise that differentiates auditors from accountants (Arens et al., 2000).

iii. Auditors

As mentioned earlier, auditors plays a very critical role in the success of an audit process as they are hired to review and give an informed and professional opinion of the state of an organization's financial books. The opinion they give has significant effects to the organization and especially to other stakeholders including lenders and clients. They assists shareholders to conduct oversight on whether the financial reporting by management is in line with the actual financial position of the organization (Krishnan & Gnanakumar, 2007). Auditors also play an important role in helping an organization conform to regulatory standards set by government and international bodies thus paving the way for accreditation. The audit report is very important to the organization as it provides areas of concern for the auditor and corrective measures recommended to rectify the mistakes. The audit process helps increase transparency in reporting finances by organizations thus enhancing corporate governance. To achieve this, the auditor has to be qualified and have the experience to carry out a variety of activities that will constitute the audit. To make an informed report, auditors need to question employees, understand the workings of the organization and analyse the documents provide to establish any inconsistencies. Any errors by the auditors may have a damaging effect on the organization and therefore their findings and opinions need to be accurate (Kolk, 2008). However, auditors are not supposed to be bound by the organization to eliminate any conflicts of interest. An auditor signs a contract with the organization giving the grounds of their relationships and the constraints including time and cost of the audit.



(RGSC and Company)

2.2 Agency theory

Agency theory describes relationships where one party contracts another to perform a task they cannot. The hiring party known as the principal determines the work to be done by the agent to complete the task. The theory presumes all involved parties are motivated by their own personal interests and for a successful principal-agent relationship the individual interests will need to be aligned. Conflict often arises in when the agent deviates from the targets of their hiring to pursue their personal interests leading to agency loss (Li, 2016). Agency loss represents the difference between the intended outcomes by the principal and the results of actions by the agent. To keep agency loss at a low, the self-interests of the principal and the agent need to be aligned and the principal needs to keep the agent in check to ensure their actions are in line with why they hired them. Agent-principle conflicts are common in auditing for various reasons when the independence of the auditing party is compromised. The main reason that leads to this is when the auditor becomes biased mostly for monetary gain. Instead of reporting on the actual state of the financial records, the agent doctors the results of the audit to please the principal thus ensuring they secure their job. Agency theory morally binds the agents and their actions by requiring them to set aside personal gains and work towards achieving those of the principal. Therefore, if the auditor is required to maintain their independence throughout the auditing period any conflicting interests are addressed before the contract is agreed. Eliminating the agent-principal problem can only be achieved by eliminating the area of conflict (Shi & Hoskisson, 2017).

2.3 Evolution of auditing

In order to make informed financial decisions, it is very important that the decision maker needs to have as much information as possible regarding the factors affecting the decision. As a result, financial auditing came into being in order to provide stakeholders of a business with an expert opinion of the company’s finances that may guide them to make appropriate decisions. The financial auditing sector is one that has been growing and changing dynamically over the years to adapt to current market demands. Auditing is an old age practice dating back to early civilizations like Mesopotamia and Rome (Byrnes, et al., 2015). It arose from the need to create controls for businesses by authorities at the time and to detect fraudulent practices. In the initial years, the main purpose of conducting an audit was to establish any malpractices by people tasked with financial reporting within organizations and not the management. After the Industrial Revolution, there was a huge growth of businesses and slowly the need for financial accountability arose. Accountants and lawyers were tasked with performing audits in the initial days but the need for professional services led to the rise of the audit profession in the early 20th century. The purpose of carrying out audits also changed from nabbing thieves to evaluating the honesty of financial records and measuring the quality of internal protocols. The profession has since grown to being a vital tool for corporate governance and preventing fraud. Methods of conducting audits have also changed over time from manual paper-based calculations to automated procedures and globally standardized approaches (Yang & Liming , 2004).

3.0 Literature review

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There are two ways to classify audits, either as internal audits or as external audits. In an internal audit employees of an organization measure its performance against the standards set but the auditors hold no interests in the results of the audit process to enforce independence (Fraser & Pong, 2009). External audits are carried out by customers, suppliers or audit firms that have no relationship with the organization. The auditor plays a very critical role in the success of an audit process as they are hired to review and give an informed and professional opinion of the state of an organization's financial books. The opinion they give has significant effects to the organization and especially to other stakeholders including lenders and clients. They assist shareholders to conduct oversight on whether the financial reporting by management is in line with the actual financial position of the organization (Krishnan & Gnanakumar, 2007). Methods of conducting audits have also changed over time from manual paper-based calculations to automated procedures and globally standardized approaches (Yang & Liming , 2004). However, the emphasis for the need of auditor independence has remained constant over the evolution period.

One of the essential factors in proper conduction of an auditor's duties is independence. Auditor independence refers to the auditors being free of any relationships with the client organizations that may influence their opinion while conducting the audit. This is necessary for both internal and external auditors to ensure they provide shareholders with a professional and unbiased opinion. All actions taken by the auditor should portray independence and judgements they make should not be influenced by any other factors involving the client organization to allow them to perform their job objectively (Austin & Siriyama, 2014).

Experts have used the agency theory to explain the concept of auditor independence. Agency theory describes relationships where one party contracts another to perform a task they cannot. The hiring party known as the principal determines the work to be done by the agent to complete the task. The theory presumes all involved parties are motivated by their own personal interests and for a successful principal-agent relationship the individual interests will need to be aligned. Conflict often arises in the when the agent deviates from the targets of their hiring to pursue their personal interests leading to agency loss (Li, 2016). Agency loss represents the difference between the intended outcomes by the principal and the results of actions by the agent. To keep agency loss at a low, the self-interests of the principal and the agent need to be aligned and the principal needs to keep the agent in check to ensure their actions are in line with why they hired them. Agent-principle conflicts are common in auditing for various reasons that result in compromising the independence of the auditor. The main reason that leads to this is when the auditor becomes biased for his or her own monetary gain. Instead of reporting on the actual state of the financial records, the agent doctors the results of the audit to please the principal thus ensuring they secure their job. Agency theory morally binds the agents and their actions by requiring them to set aside personal gains and work towards achieving those of the principal. Therefore, if the auditor is required to maintain their independence throughout the auditing period and any conflicting interests should be addressed before the contract is agreed. Eliminating the agent-principal problem can only be achieved by eliminating the areas of conflict (Shi & Hoskisson, 2017).

Several general conflict areas contribute to agency problems and consequently affecting auditor independence. One of them is advisory roles where most accounting firms in the business world also provide audit services and therefore, conflict of interests may arise when a client hires their financial advisors to conduct an audit since the auditor has a stake in the management of the client organization and may lead to a biased review. Another is internal reviews. In this case, an organization decides to perform an internal audit, those tasked with the task being employees of the organization may be very effective because of their existing relationship with the client and the outcome of the audit may affect them directly. Additionally, there is intimidation (Shi & Hoskisson, 2017). Auditor independence may be affected by threats and intimidation posed to the auditor by either the client or any stakeholders in the audit process. Further, if the auditor has any previous working relation with the client or any of its employees their credibility and ability to carry out the audit objectively.

Despite these challenges, it remains necessary that auditors maintain independence during any audit process and in their practice because of the importance, it holds to their clients, their profession and to the public. Their ability to examine financial reporting of the client organization and develop an informed opinion without any influence by the client or any stakeholders in the process determines the authenticity of the resultant audit report. It is important that audit report is as honest as can possibly be because of the stake the review holds (Abott, et al., 2016). Stakeholders of the client organization who are not able to breakdown the financial records rely on a successful and independent audit process to understand the finances. The contents of the audit report also have implications on the performance of publicly listed companies as it either inspires or destroys public confidence in the audited company (Parker, 2015). Lenders and investors also rely on audit reports to influence the extent of their relations with the audited organization.

A successful audit encourages investors to conduct business with the organization and lenders to provide financial assistance therefore it is crucial that an audit process remains independent and accurate. An independent audit may reveal instances of fraud or erroneous financial reporting thus allowing authorities investigate and prosecute offenders. Therefore, it is important that auditors observe professional ethics while conducting an audit to ensure independence of thoughts and actions throughout the process (Haste, 2015).

Governments and audit authorities across Europe in recent years have increased the efforts to establish proper audit regulations in individual countries overseen by the European Union (EU). Several countries in Europe have enacted a variety of laws that aim at enforcing their grip on corporates to promote ethical auditing and financial reporting. For instance in 2016, Germany gazetted reforms of the auditing oversight and non-audit services allowed (Warming-Rasmussen & Quick, 2015). The European Union (EU) has also laid out several regulations aiming at reforming the audit sector in member countries and boost confidence in their markets. The regulations will also facilitate better cooperation between auditors in member states that will create a strong audit market in

Europe. The current regulations that came into action in 2014 seek to improve auditor independence that will encourage investments and economic growth. The regulations include an amendment directive that lays out the frameworks for audits, enhances public oversight on auditing and a basis for coordination between corporate authorities in the EU. The regulations also require that all business entities with public interests in the EU conduct a mandatory audit of their financial records. The audits can only be conducted by auditor registered with the relevant authorities and should conform to all international regulations. The regulations also limit the non-audit services that auditors can provide to clients that they are providing audit services (Campa & Donnelly, 2016). The auditors are also required to carry out their duties independently and objectively while maintaining professional confidentiality. Auditors are also supposed to ensure they remain knowledgeable on current developments and changes in laws within their profession (Samsonova-Taddei & Humphrey, 2015).

Several instances of lack of auditor independence have rocked the finance industry. One is Enron. Enron was an energy corporation formed in 1985 that collapsed dramatically in 2001 revealing massive systematic financial malpractices including fraud and insider trading. This scandal resulted in serious damages that extended from the Wall Street thousands of employees caught up in the mess. The company that was once named the Most Innovative Company in the United States managed to mislead the public and investors for years through financial misreporting that portrayed was growing dynamically that saw its share price grow to an all-time high of $90 and billions of dollars in trading (Markham, 2015). Enron’s accountants used mark-to-marketing accounting technique to enable them hide losses made using the company’s assets and thus the company financial records always reflected profits (Markham, 2015). However, after experts began questioning its extremely good stock performance and a Securities and Exchange Commission. (SEC) investigation Enron crumbled revealing millions of dollars in debt and millions more in losses that would lead to its bankruptcy in December 2001. The role of auditors in the Enron scandal has always been an interest to finance experts. Arthur Andersen provided Enron with both accounting and auditing services and was one of the biggest audit firms at time. The firm was implicated in the scandal for it had approved all financial records of Enron's accounts despite evidence of losses thereby misleading investors and regulators. Auditor independence in this case study comes from the fact that Arthur Andersen received more money from the non-audit services they provided Enron as compared to the audit-related services. This has led many scholars to conclude that this was the reason why the audit firm willingly engaged in the wrongdoing thus showing how personal interests influence the independence of an auditor. The government also enacted several laws in the wake of Enron's collapse famously the Sarbanes-Oxley act of 2002 that aimed at reducing inaccurate financial reporting and raising the consequences of participating in corporate fraud (Markham, 2015).

Another case where auditor independence failed an organization is the Lehman Brothers fraud scandal that took place in 2008 leading to the largest bankruptcy filing of the history of the United States. The firm founded in 1850 grew into a real estate and investment leader generating billions in revenue (Dodo, 2017). A credit crisis that began in 2007 affected the housing markets in the United States and mortgage-backed securities. Lehman's shares prices also plummeted resulting in huge losses and the company received its final blow in September 2008 when stocks dropped by over 70% (Dodo, 2017). A review of the firm's accounts showed that it was involved in numerous cases of accounting fraud by removing fixed income securities from its books to mislead the investors and that the auditing firm Ernst & Young took part in the vice by passing its audit reports as accurate. Ernst & Young is one of the biggest audit firms and concerns have been raised about their involvement and the huge amounts of money they made by helping cover the bleeding finances of the firm (Dodo, 2017).

4.0 Auditors independence

4.1 Independence

Due to the significant public interest that arises from the business activities, the credibility of audited financial statements needs to be reinforced. The independence of auditors is a foundation for auditing profession which instills trust in the public. Auditing professionals perform the duty of assuring users of financial statements especially creditors and investors of the credibility and reliability of organisations financial statements. Auditor independence is defined as the absence of interest in the audit process, thus eradicating unfairness which may impact negatively on the credibility and reliability of financial statements (Schipper, 2005).

4.2 Types of independence

There are two types for auditors to being independent, they need to be independent in their mind and appearance. Apart from that there are different types of threats that they may face, which will be discussed in the next part.

Independence of Mind: This is state where the auditor needs to be totally free and independent in the way he thinks. There should be no compromise while making giving professional judgement and he should have professional scepticism (Lexiton.ft.com, 2006)

Independence of appearance: This is a state where auditors needs to be careful of various scenarios from a third party (Lexiton.ft.com, 2006). This could be for example exchanging gifts. In this situation the auditor needs to be alert, he needs to be able to judge whether he has to compromise in a future situation due to this gift.

4.3 Threats to independence

Several corporate scandals have occurred in the World which entailed the failure of auditing process such as the Enron Scandal among others. These failures will be discussed further in this thesis, also explained how it was a result of lack of independent auditors. Threats to auditors' independence could be categorised into four categories.

Self-interest Threats

Such threats are caused by financial or other self-interest conflicts which may include a financial interest in the company to be audited, or dependency on the client audit or interest to maintain a client as a result of financial benefits. Quick, Turley & Willekens (2007) argues that the auditor's fee independence is one major factor that could impair auditor's independence. In most cases, in order to retain future income, an auditor tries to retain their clients. This implies that auditor is more an auditor becomes dependent on the client with the highest revenue. The auditor would be motivated to retain such a client thus reluctance in taking actions which would adversely impact on client's interests, thus end up sacrificing their own independence. The greater the shared economic benefit between the client and the auditor, the more likely it is to impact on the auditor independence (Nasution, 2013).

Advocacy and familiar threats

Sometimes the auditor becomes influenced by the close relationship with the client. The threat may arise as a result of long working period with the same client. Davis, Trompeter, and Soo (2003) argue that the longer the auditor conducts auditing for the same client, the higher the chances of impairing auditor's independence. The impairment of auditor independence as a result of long-term tenure can occur due to various reasons. Firstly, the management can collaborate with the auditor to give a good picture of the company performance. The auditor may be influenced to adopt a position that satisfies the management. Secondly, over time an auditor experiences a belief of perseverance syndrome which is a tendency to hold original or initial belief even after new information has been received which disconfirms or contradicts the basis of auditor's belief (Anderson, 2007). In case of such an occurrence, the auditing firm may fail to review the correctness of management assertions, although conditions and facts have changed. Lastly the auditor aim at retaining a client for a long period to reduce auditor's start-up expenditure incurred in the course of the first year assignment. The auditor may end up becoming lenient with the client.

Threats of intimidation

Auditor's independence is hampered by threats of intimidation from the management for example managers may intimidate the auditor with threats of replacement. This places the auditor in a frail position as a result of asymmetrical power relationship that exists between the clients and the auditors. This is a common phenomenon due to the nature of auditing process whereby clients select the external auditor and determine the scope of their audit, and replaces or terminate the auditor. Besides this, clients provide the auditor with the information and facilities required for auditing. Even in scenarios when the auditor is selected by the audit committee, there exists no specific mechanism for enforcement to ensure clients do not engage themselves in the selection of the auditing firm or the auditing scope (Baker 2005). Thus auditors become vulnerable to client's intimidation especially in conflict situation whereby disagreements are likely to arise between the client and the auditing firm over various issues such as adjustment of financial reporting or deployment of various accounting standards among others. The auditor may also be motivated by the need to preserve their engagement with the client (Nasution, 2013).

Social Pressure

Social pressure such as conformity and obedience pressure can significantly impair the independence of an auditor. Sometimes the subordinate are forced to obey the management. The authority figure shapes the behavior of subordinates, thus they may end up not caring about their actions even though such actions contradict their personal principles and beliefs. Under obedience pressure, a subordinate may end up acting in an unethical manner as a result of lack of responsibility. The person feels responsible or liable to the authority and not responsible for their actions. In auditing organisations, managers and partners are authority figures where an auditor may be forced to obey their superiors' suggestions or commands not only to achieve rewards or avoid punishment but to preserve their occupations (Nasution, 2013). On the other hand, conformity pressure is usually exerted by co-workers. An auditor would be under pressure to conform to the behaviour or actions of the peer group. An auditor may conform to peers in order to be recognised as a group member which leads to lack of independence. This creates a situation of conformity to groups ideas and evaluations without critic. Both conformity and obedience pressures significantly impair the independence of the auditor due to power distance and individualism/collectivism actions.

4.4 Case studies

From the start of the 21st century, there have been major accounting scandals that are attributable to lack of auditor's independence. The scandals arise when trusted executives intentionally manipulate financial statements of corporate organizations to hide financial misdeeds. For example, where funds have been misdirected, expenses understated, corporate assets and revenues overstated or liabilities underreported, there is a likelihood that financial crimes will occur (Ricci, 2014). In other instances, executives steal company assets in physical or monetary form. Other times the management of a corporate organization manipulates the accounting estimates and policies to get improved financial statements. When auditors, whether internal or external, audit such organizations, the truth about the financial position of the organizations never come out as some parties have financial interests.

The law requires that the auditor should be a person with high integrity and of an objective approach. However, if the auditor is manipulated not to give full, accurate, and timely financial results, auditor independence fails. Significant scandals resulting from lack of auditor independence have fallen on companies such as Enron, WorldCom, the Financial Crisis of 2008, and Parmalat. In all these scandals, the executives had "special" relationships with the auditors and therefore cases of fraudulent invoices, falsified accounts, overstated profits, and overstated asset values arose (Peeters, 2012). Fraudulent spending, illegal payments, overstated cash flows, understated liabilities, improper booking of sales among other anomalies were never disclosed. Stringent laws in the European Union have been enacted to protect auditors' independence and deal with any corporate executives who work for their self-interests. The following section will look at each of the scandals and how they were conducted.

ENRON Scandal (2001)

In 1985, InterNorth Inc. and Houston Natural Gas Co. merged to form Enron Corp. Enron entered into the business of trading and supplying energy. The company rose very fast owing to the deregulation of the energy markets where companies could place bets on future prices. Enron Corporation had risen to become America's most innovative company by the end of the 20th century. However, fraudulent activities at the company saw it disintegrate overnight. Feffrey Skilling, Enron CEO, began to hide the company's financial losses by the fall of 2000 (Torre, 2009). The CEO used mark-to-market accounting where security values were measured on current market values rather than book values. When Enron constructed a power plant, for example, the company would immediately enter the projected profits even without making any. Losses from such projects went unreported as they were transferred to off-the-books Corporation.

Enron Corp. appeared to be making high profits than it actually did. Andrew Fastow, the company's CFO, came up with a plan to position the corporation in stable financial shape. The plan was to use special purpose vehicles (SPVs) to hide debts and losses from creditors and investors. These losses and liabilities were never entered in the balance sheet (Corner, 2014). This is how the scheme worked: The Company would transfer some stock to the SPV and get cash in exchange. The SPV would then use stock to protect an asset appearing on the balance sheet. This meant that in case the share prices of Enron fell, the ability of the SPV to safeguard the asset would be compromised. At the same time, there were conflicts of interests that were never disclosed.

The collapse of Enron caused a major dent to the financial world. Four years before the company was declared bankrupt, $74 billion had been lost and much more in pension benefits by employees (Henselmann & Hofmann, 2010). Much attention was drawn to similar companies engaging in accounting and corporate fraud. It was also established that lack of audit independence was part of the problems at Enron. Arthur Andersen LLP and David B. Duncan were the two accounting firms overseeing the accounts of Enron. Andersen was a reputable accounting firm in the US at that time. However, the firm was manipulated to offer its approval stamp for Enron even with a horde of poor accounting practices.

The law is unambiguous that all publicly traded firms should have their financial reports audited by independent external auditors without subjectivity or bias. The role of the auditor is to confirm that the client's financial statements are prepared according to the Generally Accepted Accounting Principles (GAAP). If that is not the case, the auditor should raise the alarm for the firm to be investigated. For more than three years, Arthur Andersen had been signing off the corporate reports of Enron Corp knowing that the statements lacked the integrity and accuracy they deserved (Quick, Turley, Willekens & European Auditing Research Network, 2008). Andersen conspired with Enron executives to give the proper audit certifications. The certifications indicated that the financial statements of the company had been prepared according to GAAP rules. However, the reports had violated GAAP rules and current accounting standards, therefore, exposing investors to risks.

WorldCom scandal (2002)

In the 1990s, WorldCom began acquiring firms and took the telecom industry by storm. Between 1995 and 2000, WorldCom had purchased more than fifty-five firms dealing with telecom operations. This was after the CEO, Bernie Ebbers, felt that the margins that the company received and its position in the industry were not matching. During that time, WorldCom was the second-largest phone company enjoying massive sales (Law, 2016). However, accounting fraud in the company saw it file for bankruptcy protection in 2002. One year to the close of the 20th century, there was a slowdown in revenue growth and a gradual fall of stock price. This reduced the earnings of WorldCom, therefore, increasing its expenses as a percentage of the total revenue.

The fall of WorldCom's earnings reduced its chances of meeting the expectations of Wall Street analysts. The company decided to look for ways of increasing revenue. The management of the company decided to reduce its reserves by $2.8 billion and transfer that amount to revenue in financial statements. However, the amount was still low based on the expectations of the CEO. In 2000, WorldCom started placing operating expenses as long-term capital investments on its balance sheet (Herz, 2016). Through that mechanism, they were able to hide costs and realize a whopping $3.85 billion as revenue. Revenues were inflated by transferring them from reserves to raise profits.

It is reported that as the financial condition of the company increasingly went down, major accounting misstatements were made at WorldCom. Since Ebbers had brought the acquisition strategy and wanted it to survive, he had to engage in financial gimmickry. However, the further he went on with the gimmickry, the more complicated it became. By 2001, Wall Street expected the growth of WorldCom to increase by double digits given that much had been achieved in a short period (Corner, 2014). WorldCom had acquired many companies, and it needed time to find a way of running and managing them. Ebbers never dared to give Wall Street this information but opted for doctoring of the company's books. What he needed was to inform Wall Street that the company needed time to consolidate and digest the acquisitions. If only that had been done, Ebbers would be walking freely on the streets today and not having to spend the rest of his life in prison.

In an earnings conference call with analysts in 2002, Ebbers stated that "We stand by our accounting" (Herz, 2016). What the conference attendants and the public did not know is that Ebbers had taken personal loans with WorldCom stock as collateral. Top on the purchases list was a hockey team, a ranch in Canada, a marina and a yatch construction firm. At the time WorldCom was collapsing, the board of directors came to know about the loans but never took any action as Ebbers had manipulated them.

Lack of audit independence was a critical factor in the collapse of WorldCom. The Audit Committee that met with Arthur Andersen, the company's audit firm, was loyal to the CEO and influenced the audit firm to ignore the fraudulent misstatements for 1999, 2000 and 2001. At the same time, internal accounting controls had been rendered "non-existent" (Ricci, 2014). In 2002, Arthur Andersen classified WorldCom as a maximum risk client due to its failure to follow the accounting principles. However, Arthur Andersen went ahead to give WorldCom a clean, unqualified opinion. Internal auditors whose duty was to provide independent and objective views on how the company would add value were also manipulated. They were meant to work on unnecessary projects that never had anything to do with auditing.

Auditors had limited access to income statements, and balance sheets only had a partial picture of the financial situation of the company. Ebbers directly influenced them even with the knowledge of the Audit Committee. Arthur Andersen was influenced to report that no significant or unusual transactions or material transactions in controversial or emerging areas were noted. The audit firm also reported that according to its assessment, WorldCom's process for formulating judgments and estimates for accrued line costs was effective. Andersen stated that line costs as a percentage of revenue had maintained a flat rate of 41.9% on a YTD basis (Law, 2016). It was also noted in meetings that Andersen reported having no disagreements with the management nor the management taking accounting positions that interfered with the comfortability of Andersen. Andersen said that WorldCom's processes for nine cost accruals and capitalization of the asset and that these accounts were effective. However, the reality was that all these were false statements as the management had interfered with the company's financial statements and the auditors' independence as well.

Financial Crisis of 2008

From the beginning of 2006, housing prices went down indicating that a financial crisis was on the way. The realtors celebrated the falling prices thinking that the market would come back to a sustainable level. However, these people did not realize that homeowners had acquired loans from banks with some exceeding 100 percent of the value of the homes. Some Acts including the Community Reinvestment Act and the Gramm-Rudman Act were to blame as they pushed the banks to give these loans (Corner, 2014). With this move, people were encouraged to take mortgages without knowing how far such damage would spread. However, the derivatives lost value and banks panicked. The banks had no option but to absorb the losses. No bank could lend to another, and therefore the interbank borrowing costs went high. There was a mistrust within the banking industry leading to the great financial crisis of 2008.

Auditor independence does not come out apparently on the 2008 financial crisis. However, audit firms contributed to the secondary causes of the crisis. The role of auditors is not to stop companies from making crazy business moves but to ensure that everything about the moves is disclosed (Harwood, 2014). It was the responsibility of the auditors to advise the banks on understanding the risk, avoiding bad lending and investment decisions and understanding flaws in the credit-rating system. Auditors are fully to blame for failing to pass judgment on some of the practices that led to massive losses by the government. It is surprising that how major scandals such as Enron and WorldCom had just happened, but the audit firms remained silent about the looming crisis.

Financial analysts are convinced that audit firms such as Ernst and Young had a hand in the 2008 financial crisis. According to Matt Taibbi, “The 2008 Financial Crisis was made possible by auditors and rating agencies” (Ricci, 2014). The audit firms contributed to the crisis by signing off all derivatives and bad bookkeeping in the banks and all other involved institutions. They should have been the first people to point out mistakes and prevent the crisis. Owing to the collapse of Enron and WorldCom that had been fully influenced by Arthur Andersen, the global arena should have taken it seriously to investigate all audit firms and ensure that they operated according to the set standards. Auditors’ independence lacked in that they were manipulated not to mention tax avoidance among businesses and wealthy individuals who were part of the crisis.

Parmalat scandal, Italy (2003)

Just like in the other scandals, Parmalat’s case was an issue of covering losses. When the company started making losses in 1990 the CEO, Calisto Tanzi, decided to hide the losses by manipulating the financial statements. For the next 13 years, the company took a dependent path of using unethical techniques to extend the fraud. Revenues at Parmalat were inflated through creation of fake transactions by the double-billing scheme (Corner, 2014). To make it worse, the company obtained loans from banks using the receivables from fake sales as collateral. Reported assets were inflated by creating fake assets accounts. The company also accumulated debts that were never disclosed to the investors. In addition, the company engaged in financial engineering with investment bankers to move debt from the balance sheet or fake it as equity.

In 2002, Parmalat held huge sums of cash balances whose interest was little but had high sums of debts whose interest payments were huge. That meant that the company had an "inefficient balance sheet management." Reports emerging after the fraud discovery showed that cash balances in the company were fraudulently inflated and debts understated. However, the investors knew nothing about the ongoing fraud (Lessambo, 2014). CEO Tanzi was offensive whenever analysts mentioned anything negative about Parmalat. At one point, Tanzi accused the Lehman Brothers of speculating that there was document falsification at the entity.

The company had risen to become Europe's leading dairy company. However, CEO Tanzi influenced the auditors to hide any malpractices in the company. In 1999, the firm changed its external auditors from Grant Thornton to Deloitte & Touché to comply with the auditor rotation. However, the fraud took place with Deloitte & Touché as the chief auditors but the audit form never reported any problems regarding the financial position of the company (Ricci, 2014). In October 2003, the audit firm published a report where they claimed to be unable to verify the carrying value of the company's investment in the Epicurum Fund. According to the audit firm, the Epicurum Fund did not have any marked market valuation of its assets or published accounts.

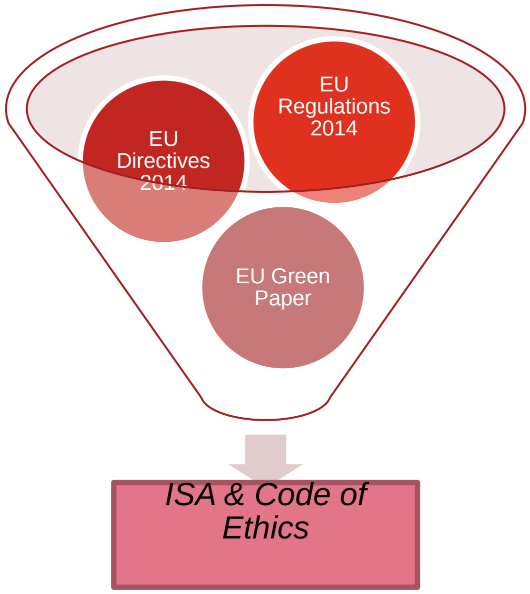
Deloitte & Touché was influenced to hide frauds by reporting that 49 percent of Parmalat's total assets and 30 percent of consolidated revenues were realized from subsidiaries audited by other firms (Corner, 2014). That meant that Deloitte's opinion was based on the opinions of other auditors. Even after the mandatory auditor rotation, Grant Thornton still audited some subsidiaries of Parmalat. Deloitte and Touché could, therefore, hide their way through as they relied on the financial audit reports from Grant Thornton. Tanzi easily influenced the audits to cover his fraudulent activities hence auditor independence was compromised. nvestigation reports after the discovery of the fraud showed that all auditors connected to Parmalat were "involved" in the scandal.

Regulations to deal with scandals and auditor independence

Europe is waking up following the reporting of accounting scandals associated with major European companies. Among the steps being taken by the EU to prevent accounting frauds include the introduction of the International Financial Reporting Standards (IFRS) to increase investor protection. The EU is working with world capital markets to build appropriate infrastructures for auditing, growing, and integrating them. The EU has realized the need for global and regional standards and regulations that limit frauds in financial reporting. The EU-level authorities ensure that rules applicable to the financial sector are implemented accordingly (Harwood, 2014). Key authorities carrying the oversight function include the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA). ESMA is responsible for creating as single rulebook across the EU, protecting the investors, maintaining financial stability in the EU, supervising convergence in the EU securities law application and supervising credit rating agencies and trade repositories.

The 2014 Audit Directive and the European Union Audit Regulation of 2014 have played a major role in safeguarding auditor independence and preventing scandals in the European Union. The Directive requires all auditors to provide objective third-party opinions that are based on the integrity of financial statements relied upon by investors to make decisions. Where the auditors collude with management to doctor financial results, there are stringent disciplinary measures on the auditors and management (European Court of Auditors, 2012). However, the Directive protects the auditors against manipulation by their clients to maintain the integrity of the accounting industry. It is required that auditors look for accurate and reliable financial statements that enable companies to raise capital. The United States has similar regulations governed by the Securities and Exchange Commissioned and the Sarbanes-Oxley Act.

5.0 Legislation



5.1 History

According to Gulin, Ferdo, Vasicek, and Lajos, (2004), the development of laws on auditors' independence by the EU has been guided by the evolution of accounting regulations. In the three stages of developing accounting regulations and harmonization, issues relating to accountability and transparency spearheaded the development of laws that govern the auditors' independence. The *Napoleon's* phase from 1807 was the first accounting phase forming basic trade laws in many European counties. Napoleon trade laws started the first phase of international accounting harmonisation where Belgium and Netherlands directly adopted the French laws. The French laws served as the basis for drafting trade laws in Sweden and Germany and later on other parts of continental Europe (Schipper, 2005.The 1807 laws prescribed on the obligation to draft the profit and loss account and the balance sheet (Gulin, 2004). The second accounting phase was the Directive phase from 1978 in which audit regulations were first derived from trade laws. The last phase consists of the IAS accounting standards and US GAAP which are EU commission publications. In the last phase, the EU developed regulations and directives for adoption.

The Eighth EU Council Directive was tasked with a duty to harmonize the conditions necessary for auditor approvals. As stated by Hart and Oulton (2001), to deal with the minimum qualification of auditors the first official proposal was published in 1978. With the development of possible changes, the proposal had an amendment in 1979 although it took a period of 5 years before the Directive had a full adoption in 1984. The delay in the Directive's approval was attributed to the EU council's inability to agree on the basic rules on independence. The directive addressed issues of incompatible activities with an aim of safeguarding the shareholder and the third party interests. It also required the member states to bind auditors by a code of ethics to compliance monitoring (Hart & Oulton, 2001.)

During the year 1975, the EU established European Court of Auditors (ECA) which acted as an independent auditor. ECA aimed at improving the manner in which the union resources are managed and significantly contributed to public accountability in regard to spending EU budget via assurance and advice. ECA was established at a time when European nations were seeking to become accountable to its citizens. Two major developments were extensions of powers of parliament in areas of budgetary control and financing of government budget from its own resources. This raised awareness of the need for independent external auditors to support the parliament and the council in ensuring there is democratic control of its resources (ECA, 2017).

In the year 1993, the European Court of Auditors later became an EU institution and was given a commission status. The parliament boosted its authority and independence. ECA produced annual statements of assurance on the reliability of EU accounts. The role of the court was strengthened with entry of Amsterdam treaty in the year 1999 that reaffirmed its independence. Its audit powers were extended to policy areas. Since the year 1977 to the court has contributed towards improving EU financial management and has acted as an independent external auditor (ECA, 2017).

The 2006 Statutory Audit laws were developed to encourage corporate governance and best practices among member states despite the difference in composition and the functioning of the audit committee in various firms. The difference in corporate governance organization impacted on the audit committee functions. Again, it required the Public interest Entity (PIE) to have audit committees. Since the audit committee has a duty in ensuring that a firm maintains proper corporate governance standards, the Directive 2014/56/EU and Regulation 537/2014 were set to enhance their role (Federation of European Accountants, 2016). The regulation and the directive guide the audit committees on issues relating to auditor selection, independence, monitory and conflict of interests of the external auditor.

In a nation such as UK, standard setting was adopted in the year 1989 by the Accounting Standard Board (ASB) that proceeded to issue better standards to address various problem areas such as capital instruments, off-balance sheet finance, mergers and acquisitions among others. The standards later moved to high-level standards that were more detailed and rigorous. This gave to rise of International Accounting standards (IASB) and also led to widespread adoption of IFRS (ICAEW, 2017).

5.2 Current laws

The legislation relating to the independence of auditors includes various requirements that would promote investors understanding of the audit process which includes critical judgments done during the auditing process. Current laws contain detailed provisions that affect statutory audits. Auditors are required to carry statutory audit in compliance with international auditing standards (ISA, ISQC1) among other related standards that are issued by International Federation of Accountants as adopted by the EU (Schipper, 2005).

The current laws were adopted in the year 2014. They aim at improving statutory audit in the EU through reinforcing auditors' independence and their professionalism towards management of audited companies. For the case of public interest entities, mandatory rotation of auditors on regular basis is compulsory. The auditors are also not allowed to provide any non-audit services to clients. Public interest entities include credit institutions, listed companies, insurance companies or other undertakings designated by the EU countries to be of public interest.

The current rules consist of an amending directive- 2014/56/EU which sets out the framework for statutory audits and rule for auditors' independence. It strengthens public oversights towards audit professions and enhances cooperation between competent authorities in the European Union. The special provisions for statutory audit of public organisations set out in the Directive 2006/43/EC have been reinforced further in EU regulations No 537/2014. It is required that statutory auditors remain independent while carrying out statutory audits and conflict of interests should be eradicated. Audit firms should refrain from carrying audit in organisations they have vested interests.The auditor should refrain from participating in internal decision-making process of the audited company (European Union, 2017).

The current rules also comprises of regulation- 537/2014 which specify requirements for statutory audits of public interest entities such as banks, companies and insurance companies. The regulation demands that national authorities responsible for oversight of audit and the European commission network to come up with a report on development in the national markets (European Union, 2017).

The Committee of European Auditing Oversight Bodies (CEAOB) was set up in 2016 and aims at improving cooperating between national audit authorities in the EU. The body contributes to the proper application of EU auditing legislation through facilitating supervisory convergence. EU legislation on statutory audit requires mandatory auditors' rotations for public interest entities. The core requirements is a 10-year audit firm rotation if a tender is undertaken or 14 years in case joint audit is adopted (PWC, 2017). The current laws also require establishment of audit committees which oversight the overall audit performance. There are also additional restrictions in regard to the provision of non-audit services by the auditing firm (PWC, 2017).

Europe has adopted International Standards on Auditing (ISAs) that have been issued by the International Auditing and Assurance Board (IAASB) (Quick, Turley & Willekens, 2007). ISAs have played a key role in guiding auditors and building investors' confidence. ISAs can be grouped into seven key categories that include respective responsibilities, internal control, audit planning, use of other experts work, audit reporting and specialised areas. ISAs guides the conduct of an auditor in accordance with the international auditing standards. ISAs also specify auditors responsibilities in relation to fraud in audit of financial statements. ISA also specifies the duties and responsibilities of joint auditors. ISA also specifies communication criteria with the management and also helps auditor in the planning of audit process. European Union has enforced directive in regard to the use of ISAs for all statutory audits. The Union has further established the European court of auditors which performs audit in based on INTOSAI and IFAC international auditing standards as applied in Europe (IFAC, 2017).

Comparison of EU and US regulations

There are major differences in financial reporting between Europe and US. The Sarbanes-Oxley Act (2002) was meant to address all the auditor independence issues, however, the revised 8th directive provided a minimum of harmonisation for European Union member states. This difference was due to the fact that, European Union member states having different national requirements required flexibility to add local requirements as appropriate (Strohm, 2007).

The American regulation mandates only the independent or the non-executive directors could serve in audit committees. However, the European directive allows audit committees to include various executive members with the requirement that there should be one independent member who is competent in audition or/and accounting. In regard to audit firm rotation, the US has rejected the option of mandatory rotation of the whole audit firm and senior partners, while the EU has maintained the practice (Strohm, 2007).

5.3 International Standards of Auditing (ISA)

ISA stands for International standards of auditing. These standards are expressed by the International Federation of Accountants through the International Auditing and Assurance Standards Board (IAASB). According to the new directive issued by the EU in 2014. It requires all statutory audits to follow these standards. There are 36 international standards on auditing. Each standard has its own objective. These standards are laid out in different sections which include: Introduction, Objective, Definitions, Requirements, and Application and Other Explanatory Material. In the introduction part the ISA standard is introduced and briefly explains the purpose of the standard. It also mentions the content matter of the ISA including the duty of the auditors or any other party that it applies to. In the objective part the ISA standard is clearly explained while focusing on the objective of the standard. The third section gives the explanations of the standards. The fourth expresses the requirements. This is quite important as this explains how the standard should be applied and how it should meet the requirements. In all the standards, they have used the words “the auditor shall”. This states the importance of the standards and all auditors shall apply these rules. The last section application and other explanatory material explains the requirements further and more precisely. These explanations include the purpose of the standard and why and how it is required, sometimes it also have examples. These examples may be in any given circumstance (Iaasb.org, 2015).

The standard that is related to auditor’s independence is ISA200 “*Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing”.* This is also the first stated standard issued and approved by the International Auditing and Assurance Standards Board (IAASB) in April 2007. This standard as the name says is about the responsibilities of an independent auditor while auditing the financial statements. It further elaborates about the role and scope in order to meet the goals of an audit. It also explains the structure of the standard and how it should be applied. Although the standards are designed to help auditors to audit financial statements, it is still the auditor’s responsibility to comply with any relevant laws or regulations that may apply while auditing. As explained further above, the main objective of conducting an audit is to ensure the information given in the financial statements reflects a true and fair picture of the company. Therefore this ISA200 standard helps the auditors to reach that objective. Even though the financial information that is audited is prepared by the company's management, ISA do not force obligations on the management and do not abrogate laws and directions that oversee their duties. This standard also requires the auditor to have an opinion the audit conducted. It requires the auditors to obtain assurance about the financial statements are correct and free of any miscalculations, fraud or any other mistake. By giving reasons it is assumed that the highest level of assurance is obtained. As by confirming the things stated above, the auditor minimizes the audit risk and ensures high level of audit, even though it is not the only way of ensuring high level of assurance. ISA200 also requires the auditor to give a professional judgment and keep professional scepticism throughout conducting the audit also the planning before that. IAS200 also requires the auditor to raise his opinion when sufficient assurance is not obtained (Ifac.org, 2009). IAS200 provides definitions for different objectives of auditors such as audit evidence, audit risk, detection risk etc. These are the same as explained in this paper earlier, however the definition of an auditor to IAS200 is:

"The person or persons conducting the audit, usually the engagement partner or other members of the engagement team, or, as applicable, the firm. Where an ISA expressly intends that a requirement or responsibility be fulfilled by the engagement partner, the term "engagement partner" rather than "auditor" is used. "Engagement partner" and "firm" are to be read as referring to their public sector equivalents where relevant" (Ifac.org, 2009).

Another thing IAS200 focuses on is the auditor being professional scepticism and judgement, their definitions are provided below respectively:

"An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence" (Ifac.org, 2009).

"The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions

about the courses of action that are appropriate in the circumstances of the audit engagement." (Ifac.org, 2009).

As mentioned before, ISA rules are to be followed by auditors and they focus on improving the quality of the audit. For implication of these rules it is very important for an auditor to be independent. Such as, for giving a professional judgement or being sceptic, the auditor needs to give fair decisions and indicate possible misstatements if any error or fraud is detected. Considering the objectives of an auditor according to ISA, the auditor has to be independent. They have to be independent mentally and in their appearance, only than they can fairly audit the financial statements and communicate freely. Another requirement of ISA about giving a fair opinion on anything they disagree also depends on the independence which further leads to the way they see the audit evidence; the information used to come to the conclusions on which the opinion is based. Therefore, auditor's independence is very crucial in order to apply these International Standards of Auditing properly and effectively.

As seen above, the ISA requires auditors independence indirectly, further we will look at the code of ethics for the professional accountants.

5.4 Soft law; Code of Ethics for professional accountants

The international ethics standards board for accountant (IESBA) creates and promotes these standards of ethics. IESBA is an independent organization with a purpose of serving the general public interest by providing these high quality code of conducts. IESBA's long-term goal is joining of the Code's ethical models for accountants, also counting for auditors' independence standards. By joining the ethical standards to one global set of standards, will improve the quality and consistency of services given by accountants, in the world. There are a total of 18 members that are selected by the IFAC Board, approved by the Public Interest Oversight Board (PIOB). Meetings where members are selected have to be transparent and open for the general public. IESBA's independence is defended in various ways, such as;

- PIOB oversees the whole process independently and formally.
- PIOB also oversees the nomination and selection procedures
- General public have access to meetings and any other material.
- Consultative Advisory Group observes the standard setting procedure
- IESBA members are required to commit to the boards independence and the mission of public interest.

It is very crucial that the standard setters work independently with full honesty and transparency.

Further coming to the code, in section 100.5 it requires the accountants to be fully straightforward, honest and professional. It also requires them to give a fair judgement which is not affected by any third party (International Ethics Standards Board for Accountants 100.5, 2017).

Another part of the code of ethics deals with conflicts of interest. In section 220 the code talks about an accountant having conflict of interest when providing services. This can be linked to agency theory discussed earlier in this paper, such conflict of interest may harm the quality and transparency of the work, hence not showing a fair and true picture. The law again appeals the accountant to be totally independent and give his professional and best judgment (International Ethics Standards Board for Accountants 220.1, 2017)

Examples where conflicts may arise can be linked back to types of threats to auditors independence, an accountant may be giving advisory services to a new client and may help this client to get the audit of a firm. As long as this is the case, there is absolutely no issues. However if he have any previous confidential information about the firm due to previous relations, then the problem arises, as the accountant have used insider information to help his new advisory client to get the audit client. Another example of conflicts of interest could be advising two customers that are competing with each other, simultaneously. Or representing two companies that have a legal conflict. Another famous example also discussed in the audit scandals is when an accountant advises a client where he or any other family member may have financial interest in. These are some of the situations where there may arise some conflicts of interest and where an accountants independence may be threaten.

Section 220.3 of the code, tells the accountant to identify such interests or relations that might arise conflicts of interest. After identifying the accountant should try to eliminate the threat by implying to the suggestions of the code. Whereas section 220.5 advises in cases where a conflict is created and the accountant may not be able to reduce the risk, the code advises the accountant to discontinue the services. To avoid being in danger of not following the guidelines, section 220.6 gives some checklist for the accountants before accepting a new client. The code advices that the nature of the interest and relationships of the clients and also the nature of the services that will be provided, should be tested before any client should be taken (International Ethics Standards Board for Accountants, 2017). Apart from this, the code also guides against taking gifts or any other hospitality as that might also give a soft corner for the client.

In section 290, the code addresses the independence duties for an auditor and review engagements. As discussed earlier and seeing the crimes committed in the scandals, the code says that they auditors should be independent mentally and in appearance.

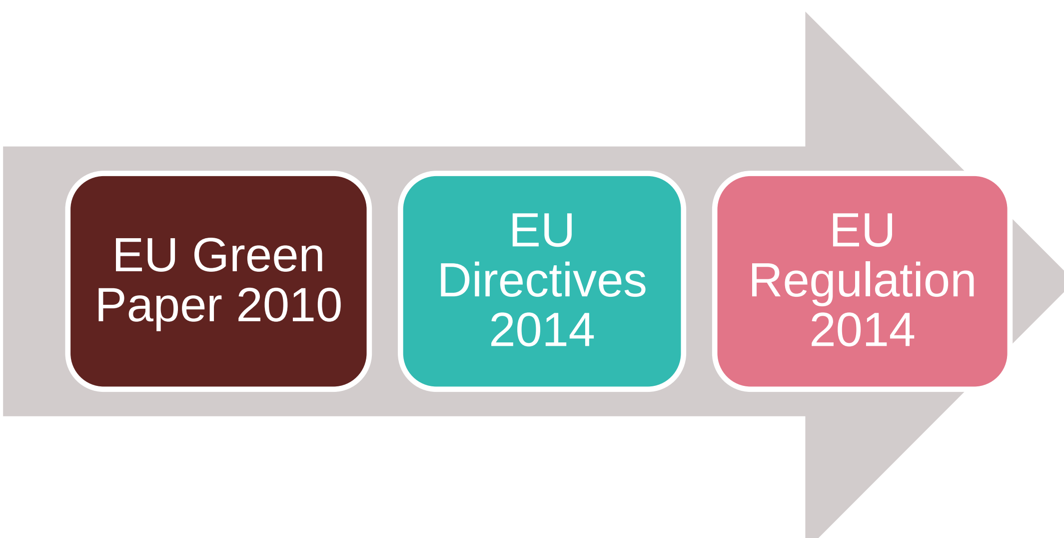
I. Independence of Mind: This is a position that allows the auditor to express his opinion without anyone forcing him mentally. The auditor needs to exercise professional scepticism. Auditors also need to give their fairest judgment and act with honestly.

II. Independence of Appearance: This is a position where the auditor needs to avoid any third party information that may affect the situation or facts. The auditor needs to be fully ensured that the honesty, objectivity or professional skepticism has not been compromised of the workers of the company.

Again the law emphasizes the accountant to use conceptual framework which tells them to identify any threats to independence, assess the impact of the threat and secure, when needed, to dispose of the threats (International Ethics Standards Board for Accountants 290.7, 2017). There may be many other ways that may be relevant in detecting threats, but it is not possible to consider the different situations, therefore the code has laid out a conceptual framework.

5.5 EU Green Book

In 2010 the European Commission issued a green paper called “Audit Policy: Lessons from the Crisis”. In this paper they discussed different measures that could applied to overcome the financial crisis of 2008 in the EU. Apart from that they also discussed the different players and their respective roles that led to the crisis. While the part of banks, hedge funds, supervisors etc. has been addressed and examined inside out in numerous examples, there has been constrained consideration on how Audit firms may have contributed in the crisis and failed to live up to perform their duties. They further discuss measures and ways to prevent these events from happening again in the future. The summary and key measures are noted down, further taking them in the Directives and then the final Regulation is prepared.



Between 2007 and 2009, there were many banks that were recording big losses however they were given green light by the auditors. As discussed earlier, auditors or audit firms could play a vital role in maintaining financial stability in the market. Their role is to ensure that the financial statements show a true and fair picture of the company, but they need to fully independent and without any interest involved. For example, like stated above banks were recording huge losses in a period of two years but still got a clean chit, maybe the auditors should have been more alert and considered why there were big losses and what the banks were planning to do in the future to prevent such losses. The EU also expresses concerns about big firms often labelled as the “Big Four” are growing bigger and bigger every day, and getting the maximum market share of big companies. This is concern as if one of the big audit firm collapses not only will it affect the trust and confidence of the investors but it will also have an impact on the financial systems stability. This can specially be linked to Enron, discussed in the Scandals section of this work, where we could see Arthur Andersen collapsed. This concern arises the question of as quoted in the EU Commission, “too big to fail.”?

There was called a House of Lords inquiry which was based on the competition in the audit market in the UK. This inquiry also blamed the auditors of the banking section to not fulfil their role efficiently before the crisis. However looking at the legal perspective, the inquiry agrees that the auditors may have done their job but should have been more proactive by letting the management know about the financial situation of the banks in the period of 2007 to 2009.

Another thing problem that is discussed in the inquiry, is the dominance of the big four in the market. In 2011, according to this rapport, there was only a single company in FTSE100 that had another audit firm than the Big Four. The inquiry’s concern was, as mentioned earlier, another collapse like Arthur Andersen. To cope up with this problem the inquiry suggested that there should be a rotation of audit firms every five years and increased involvement of second-tier auditors such as BDO and Grant Thornton, in the financial sector (Johnson, 2011).

Considering such inquiries and other analysis, the European commission felt the need to strengthen laws for auditors. The following restrictions were mentioned and briefly discussed in the Green Paper:

- Mandatory Rotation
- Non-Audit services
- Fee Structure
- Publication of Financial Statements
- Group Audits
- Joint audits (two auditors)

These were some of the suggestions that came up in the Green Paper, they were only explained briefly with an expansion in the Final Regulation. After the Green Paper was issued, there was an open forum where stakeholders could question or make some inputs to the Green Paper. Once all the steps were completed, a Final Regulation was published in 2014. In this Final Regulation, some of the restrictions made in the Green Paper, were included and explained in more depth. The Final Regulation is discussed further below.

5.6 Directive 2014

A directive contains some results that every member state must achieve, however it is up to the Member States to decide whether they transpose the directives into national laws or not. Whereas, a Regulation is a legal binding that must be followed by all Member States on a specific date.

The EU Directive 2014 is a succession of the EU Directive 2006. In this paper, the EU Directive will not be discussed in depth, rather some points will be discussed. In the next part of this paper, the EU Regulation is thoroughly discussed therefore the need for the Directive to be discussed thoroughly is limited.

Article 1 of the Directive says that there is a need to protect the various investors by strengthening the laws of auditor's independence and to minimize the risks associated with independence. Article 6 continuous on the same point by adding that any statutory auditor who is auditing should make sure that he/she is totally independent from the audited firm, also making sure that the auditors does not have the power to influence any decision-making. It further says in case there are threats to independence, they should be safeguarded or worst case scenario the auditor or audit firm should resign from the audit engagement.

Article 7 in the Directive advises that any kind of conflict interest should be avoided, not only by the audit and audited firms but also by any network that these firms are associated with. The requirement for being independent is also not just for the time being audited but it also includes the period of the audit report and the period where statutory audit is carried out

The Directive also addresses that there is also a responsibility on the internal management of the audit firm to ensure independence. The internal organization should be alert of the threats to independence and should not carry out an audit engagement if they are in doubt. The management should also ensure the employees working under them are independent, this can be done by strict internal rules and regulations, such as, requirement of signing and confirming independence before being assigned to an audit engagement. As article 10 states, whatever these internal policies may be, they should just ensure that the audit is carried out completely transparent, independent and of high quality.

Article 18 in the Directive, advises the statutory auditors or audit firms to adopt standards that in respect to professional ethics and high quality internal control. Such firms should also provide education on such matters to its employees, such as different courses etc.

The EU Directive 2014 have many points on different areas of auditing but as mentioned above only some the points are discussed from the Directive, based on the need in respect of the Regulation.

5.7 EU Regulation 2014

In this section, the laws and regulations in the EU on auditor's independence will be looked at. Considering the recent accounting scandals and the financial crisis in 2008, the EU has passed a new legislation in 2014. This legislation will be described and summarized to see which parts of the law have been passed that will prevent future scandals or crisis.

The EU Legislation was adopted in 2014. The purpose of this legislation was to improve/rebuild the market of statutory audit. According to the legislation the statutory auditors have a very important role to play in the world;

"*Statutory auditors and audit firms are entrusted by law to conduct statutory audits of public-interest entities with a view to enhancing the degree of confidence of the public in the annual and consolidated financial statements of such entities. The public-interest function of statutory audit means that a broad community of people and institutions rely on the quality of a statutory auditor's or an audit firm's work. Good audit quality contributes to the orderly functioning of markets by enhancing the integrity and efficiency of financial statements. Thus, statutory auditors fulfil a particularly important societal role.*"

The legislation includes many different areas around auditing, however in this section I will only be focusing on the points that have an effect on statutory audits and which are a requirement for public interest entities (PIE).

Definition of PIE

- Public entities of interest is a firm or company that is listed on a regulated market.
- PIE also include all EU credit institutions, however, they do no need to be listed on a regulated market. These credit institutions are those that are legitimately characterized as taking deposits from the general public and to allow credits for its own record. Examples of such credit institutions are banks etc.
- All types of insurance taking in the EU, these institutions does not need to be listed to be defined as PIE. Also, it can be any type of insurance institutions such as life, non-life or institutions that do reinsurance.

- Companies that are otherwise stated as public-listed entities, these could be due to any reason such as the type of business that they do, the size of the company or number of people working in the company.

It is not always the case that a subsidiary of a PIE is also a PIE. For the subsidiary to be a PIE, it has to be listed separately in a regulated market or any of the 3 mentioned conditions listed above, in any EU country.

Audit fees & NAS fee cap

According to the Legislation, there are 3 restrictions that needs to be followed, when it comes to Audit fees. These restrictions are mentioned in Article 4;

I. The first restrictions is that the audit fee must not be conditional or contingent. As explained in the Directive 2006/43/EC, contingent fees are those fees that are dependent on a certain result or the work performed.

II. Non-audit services apart from those mentioned in Article 5.1 in this Regulation, should be capped to 70% of the total average cost paid in the last three consecutive years. This condition applies when an auditor or audit frim has audited for a company, its mother company or any other controlled undertakings, for at least three consecutive years. The capped fee of maximum 70% can be applied to the audited firm, or if applicable to its parent company, controlled subsidiary or of any consolidated financial statements of the group of undertakings. Non-audit services in Article 5.1 will be discussed further below.

III. The auditor or audit firm has a duty of disclosure if 15% is received in each of 3 consecutive years, of the total annual fee from one company of public interest. The Audit Committee shall assess whether the auditor's independence is threatened and whether there is one quality assurance audit of the audit before the endorsement is submitted. The Audit Committee shall continue to assess if the total fee still accounts for over 15% from one company, if it will be sound to have the same accountant. If the fees continue to exceed 15% the audit firm or auditor may only continue with the audit for a total of two years.

Prohibition of the provision of non-audit services

According to the legislation, there are some restrictions that needs to be followed, when it comes to prohibition of the provision of non-audit services. These restrictions are mentioned in Article 5 of the legislation. There are some services that an auditor or audit firm may not provide to a PIE. These restricted services also apply to any network that the audit firm is part of and includes all audited firms, their controlled undertakings or any parent company. These restricted services are listed below from Article 5.1 from the legislation;

a) Tax related services:
   i) May not prepare tax forms.
   ii) May not file payroll tax
   iii) Custom duties
   iv) The may not identify public subsidies or any tax incentives, unless the law requires the auditor or audit firm to do so.
   v) The auditors may not give any support if there is a tax inspection by tax authorities, unless support of the audit firm is required by the law.
   vi) May not help with calculating direct or indirect tax, neither deferred taxes.
   vii) Provision of tax advice.

b) Any assistance that include having an influence in the management or decision-making of the audited company.

c) They may not help in preparing accounting transactions and financial statements, including book-keeping.

d) The may not help with payroll assistance.

e) May not have any kind of involvement in the process of preparing and completing internal controls, financial information controls or technology systems.

f) They may not provide any valuation assistance including any services for actuarial or litigation services.

g) There are also some restrictions to legal services, such as:
   i) Provision of general counsel.
   ii) They may not negotiate on behalf of the firm
   iii) They may not provide any advocacy support in resolution of litigation.

h) They may not have any involvement in the company's internal audit system
i) Any assistance related to financing, capital structure or assistance in investment strategy is also restricted. However it is allowed to provide assurance services in relation to the financial statements.
j) Any sort of activity related to the audited companies shares – such as promotion of the company, dealing with shares or underwriting shares.
k) Some human resource services such as:
    i) Manage a position where you may have an influence over the process of preparing accounting transactions and financial statements that is subject to statutory audit. Provided that such assistance include:
        (1) Looking for or selection of candidates for such posts
        (2) Checking the references if candidates for such posts
    ii) Helping with the organizational design
    iii) Cost control

Apart from the services listed above, the Legislation also gives permission to any member state to restrict an audit firm from other services, in case they feel that the their independence might be threaten. In case a network company, of either the auditor firm or audited firm is in corporation in a different land, the auditors firm should assess whether they fell their independence is compromised or not. If the independence is compromised, the legislation advises the audit firm to either minimize the threats or in case that does not work out, it should not provide services or assistance to that PIE.

Preparation for the statutory audit and assessment of threats to independence

According to the legislation article 6.1, a statutory auditor or auditing firm have to check whether they comply with the requirements of article 4 and 5. Apart from this they also need to check whether they meet the conditions of article 17, which will be discussed later. If these conditions are met only than a statutory audit or audit firm may accept an audit.

According to the legislation article 6.2 a statutory auditor or audit firm also have to confirm in written that they are independent from the accepted company and in case they feel there are any threats, they need to discuss them with the audit committee.

Duration of the audit engagement

In the Legislation Article 17, there are some restrictions and policies about the duration of time that a PIE may have a statutory auditor or audit firm. A PIE have to have the appointed audit-firm for at least 1 year, but for a maximum of 10 years. After the maximum period of 10 years is over, it is not allowed for the statutory auditor or the audit firm to take the same PIE within for a maximum of 4 years. This restriction also applies to any firm in the network of the audit firm. The rotation is not just for the auditors that are signing the financial statements, but for the whole audit firm.

However, the legislation does give room for more extension. According to the law there is an allowance for the Member States to determine the rules themselves in the context of the framework. This means that they can extend or shorten the maximum duration of the auditors. Member states may extend the duration up to either 20 or 24 years in case there are a minimum of two statutory auditors or audit firms. These two statutory auditors needs to be on the PIE simultaneously. However, the signing auditors must be replaced after 7 years, and may not be on the same PIE for another 3 years. The law also gives the authority for the Member States to shorten this 7 years period, if there is a need for it.

The statutory auditor or the audit firm should build a proper continuous rotation structure of the most senior faculty engaged with the statutory review, including any auditors that are statutory auditors.

The last rule for rotation, is that the duration period starts from the first financial year from where the statutory auditor has been appointed. However, in case the statutory auditor has been on a PIE that has either merged or has been acquired by the current PIE, it still counts.

Looking at the Legislation above, we can see that there have been made some restrictions on different areas. The audit fee have been capped and the duration of the statutory audits have got some limits. However the area where there have been major restrictions are the non-audit services. The EU legislation have really taken a hard stance on the non-audit services, which does indicate that the EU feels that this is the area where auditor’s independence is threaten the most.

6.0 Analysis

The analysis is based on the affect that the EU Audit Regulation may have had on auditor's independence. Previous mentioned scandals will be analysed in respect to the final regulation to see of the loopholes have been covered. In this section, studies conducted on the changes made in the Regulation, by different parties, will also be analysed. Apart from that, the different threats to auditor's independence will be discussed in respect to the laws created to minimize these threats. Apart from this, the responses that the European commission got for the Green paper will also be analysed. The European commission got almost 700 responses from stakeholders across the world. These stakeholders including the big four, SMP's, investors, academics and public authorities. There were mixed replies, some believed the new suggested regulation would enhance auditor's independence while others disagreed.

6.1 European Regulation

As discussed in this paper, the EU is worried about auditor's independence while conducting an audit. As stated in the Green Paper, the European Commission felt that there was a need to strengthen the laws to minimize the threats to auditor's independence. Therefore, they came up with an updated Regulation in 2014, where they introduced different laws such as cap on NAS, mandatory rotation and prohibition of some NAS completely.

6.1.1 Fee cap on non-audit services (NAS)

Apart from those that have been restricted by the EU, there are other non-audit services that an audit firm may provide. The EU has passed this regulation in order to increase competition in the market while safeguarding auditor's independence. The regulation states that permissible non-audit services may be provided, however there is a fee cap on them. Any non-audit service that may be provided must be capped to 70 percent of the average audit fee charged for three years. For example, if a statutory audit firm charges a PIE EU100 for an audit engagement per year, for three consecutive years it would be EU300, therefore it must not charge more than EU210 for any NAS provided. This has made statutory audit firms to rethink about which services it should provide to its clients, and which it should stay away from. According to a survey on FTSE 100 companies, many of these firms were in a dilemma and were reconsidering the amount of non-audit services they should get provided by its auditors. In the same survey it was discovered that 13 companies in the UK paid more than 70 % for non-audit services. For example, PwC were the auditors for London Stock Exchange Group in the period of 2012 and 2013. In 2012 they paid PwC £2.9 million for NAS whereas for audit services they only paid them £1.4 million. In 2013 again they paid £0.9 million for NAS compared to £1.6 million for audit work. Even though majority of the non-audit services were corporate work in relation to mergers and acquisitions advice, it still made to reconsider whether they should continue with audit work or leave it.

For instance, if we assume that this same situation happened after the new regulation and hypothetically use the same fees for audit services. In this case, let's say in a period of 2012-2014 PwC charged £1.4 million, £1.6 million and £1.8 million respectively, for audit services. So, according to the new regulation PwC were only able to charge a max of 70% of the average of the audit fees, making that £1.6 million. Coming back to the survey, PwC also got replaced by EY for audit services. In the same survey it shows that a FTSE 350 company gave a huge order of non-audit services work to its auditors, which led to an audit tender. This shows that audit firms and audited firms have to think twice before deciding which services they deal with.

The fee cap on non-audit services may not be linked with any threat to auditors' independence directly, however it is still very important as it minimizes many risks that may affect them indirectly which can also be seen in the next part.

Big four

According to EY, public interest entities face a challenge of deciding which professional services they should receive, not just from whom but also when and where they should receive them. PIE decision will be based on their strategic goals (Ey.com, 2018).

According to Deloitte, these restrictions have been made to enhance corporate governance and to strengthen transparency to parties involved.

The big four did not have much focus on this rule as this focused more on the prohibition of some non-audit services.

6.1.2 Prohibited non-audit services (NAS)

EU

This restrictions have gained much popularity for those that agree with it and also those that disagree with it. In the Green Paper and then further in the final regulation, the EU restricted many services that an audit firm could not perform. The EU believes that these services creates a risk and threatens auditor's independence. They also believe that providing certain services arises the risk of being too informed leading to familiarity threat. As discussed earlier the EU suggest that if there is any doubt regarding independence, the auditors' should immediately resign from that engagement.

Out of the 700 responses, most of them showed disagreement on prohibiting non-audit services. On the other hand, the rest believed that there should be more strict rules for PIEs'.

Big four & SMP

The big four that plays an important role in the auditing world, believed that the restrictions on non-audit services would not benefit and hence opposed the prohibition. In the response sent to the EU, the big four claimed that by restricting non-audit services the EU would weaken the general economic independence of auditing firms as they would not be able to use their skills and expertise in those services. They believed that by banning such NAS, there would be an overall loss in the service sector. The big four further claimed that there were already more than enough requirements on independence and they were enough to disclose anything in case auditor's independence was challenged. Big four suggested that the audit committee could be used to approve such non-audit services. However, on the other hand medium and small size audit firms had a mix view about this restriction. Some believed it to be a positive initiative and believed that the independence would be safeguarded. At the same time, SMPs' believed that the restrictions should only be valid on PIE's, as the SMP's needed to provide such service otherwise they would have a hard time to exist.

Investors & Academics

The investors generally meant that services that an auditor had no connection to should be restricted as they meant that was the root for conflict of interest. They also felt that there should be laws and regulation for minimizing such risks. Whereas some investors suggested that the EU should precisely mention the non-audit services that are allowed for auditors to perform. They believed that there was a confusion and there might have been some services that might fall under a grey area, where it would not clear whether an auditor could provide the service or not.

Generally academics also agreed with this restriction on non-audit services. They believed that for auditors to stay away from non-audit services would assure independence. They also believed that from a third person's perspective, auditors' independence would be highly efficient and would leave no doubt in their minds, if they were restricted from non-audit services. Another factor for academics to support this ban was that they felt restricting auditors to perform non-audit services would assure auditor independence in appearance. Another positive effect of this ban according academics was that audit firms' total remuneration would not be depending on one single customer (Ec.europa.eu, 2018).

The above are some of the responses that the EU got after issuing the Green Paper. By analysing these it can be seen that most of the stakeholders are positive about the restrictions of non-audit services. On the other hand, the big four and smaller accounting firms believe that it might have a negative effect, as the big four believes that the expertise they have will go to waste, whereas, the smaller firms will have a hard time to exist. In the next part, there will be an analysis of the restrictions with empirical evidence.

Practical evidence

A research was conducted by Yu Zhang, David Hay and Claus Holm to see if there was any relation between non-audit services and auditors' independence in Norway. The long ending debate about whether non-audit services has any effect on auditors' independence, on one side there are believers that say that non-audit services creates a special bond between auditors and the audit firm whereas on the other hand, there are believers that say that NAS has no effect at all. In this research the authors selected 138 companies and extracted their financial statements specifically pointing out audit fee, non-audit fees, auditors' opinion, their information and data about the subsidiaries. The data that was analysed failed to provide any evidence that these two factors were related. Even though audit fee and non-audit fee were interrelated, but there was not enough evidence to support that it had any effect on independence. On the other hand, provision for NAS had no effect on the length of the audit tenure. Therefore the authors concluded that there was no evidence to support that any independence whether it was appearance or mind, was effected by non-audit services (Tandfonline.com, 2016).

Whereas on the other hand, the head of BDO UK, Scott Knight, gave an interview in 2018 where he meant that the current rules and restrictions on non-audit services should be tightened more. He believed that due to non-audit services some firms had comparative advantage over others, making it unfair for some firms. He also mentioned how there still were some grey areas where there still was confusion and how big firms were taking comparative advantage of this.

"*The rules are too confusing and it's too easy to trip up. I would love there to be a really clear black line. The rule should be if you do the audit, you can only do audit and audit-related work. Audit committees should have a really clear demarcation*."

He further said that there still are some services that are allowed, which may create conflict of interest and harm the overall audit quality. Another issue that was raised in this interview was that big audit firms would offer low audit services just to get in the company, than they would score fruitful non-audit services. This was another comparative advantage that the big firms had as not all firms may be able to offer low audit services (Ft.com, 2018).

Another point to support the ban is the 2018 liquidation of a British multinational company, Carillion plc. They provided management and construction services since 1999. The liquidation of this company has caused many in the UK to question the role played by the big 4 accounting firms, PwC, Deloitte, EY and KPMG. In January 2018 Carillion plc went to liquidation with liabilities amounting £7 billion whereas they only had £29 million to cover them.

The big four accounting firms in UK were all somehow related to Carillion plc. Deloitte was the internal auditors for them, KPMG were the external auditors, EY were providing them advice on turnaround whereas PwC were advising the company in relation to pension schemes and government contracts. As KPMG were the external auditors, they are currently being questioned whereas the other 3 are still to be considered. This recent break-down of a major company has hit the UK market crucially as investors and general public has lost faith in the concept of auditors' being independent (Ft.com, 2018). According to another article related to liquidation of Carillion plc. 97% of the 350 biggest companies are audited by the big four in the UK, and after the failure they are seriously questioning the whether they can be trusted or not. As quoted from the article

"*There could have been no Enron without Arthur Andersen's complicity; no subprime crisis without AIG selling out. There could have been no Carillion without the Big Four accounting firms"*

As the big four companies failed in this case, even though they still are providing justification, the UK government has considering two solutions. The first solution that they are considering is to break up the big four into smaller companies. The other solution is that the big four split the audit part and the consulting part as having them both under one roof creates conflict of interest (Boing, 2018).

Members of Parliament in the UK believes that the audit quality is decreasing when firms are providing non-audit services in respect to Carillion plc. The committee that were considering the two solutions, believes that too big firms enjoy a rather cosy relation with their clients, and just like in the case of Carillion plc. KPMG never showed any signs of upcoming problems. After this failure, the UK are considering to apply the method that France are using. This is when small firms jointly audit bigger companies. This way they cross check the work performed by the small audit firms hence improving the overall quality and making it more reliable (The Independent, 2018).

Even though there are numerous articles, studies and journals that support the no-relation between auditors independence and non-audit, such examples such as Carillion always creates the doubts again. With non-audit there will always be a doubt whether the auditor is safeguarded from self-interest and familiar threats. The studies in support of this ban, use the argument that audit firms sacrifice the audit quality by being more lenient to get lucrative non-audit services in return. When the auditors' have self-interest or familiar threats, it leads to major accounting scandals.

As also seen in the scandals discussed earlier in this research, Enron Scandal also happened due to self-interest of the auditors. In this case Arthur Andersen, the auditors' of Enron not only audited but also provided services for taxation and consulting. In 2000, Arthur Andersen charged $27 million for taxation and consulting where as they charged $25 million for auditing. Arthur Andersen did not perform and their duty of verifying that the financial statements showed a fair and true view of the financial position of the company was compromised. Even though it was part of the "top five" in the US with PwC, KPMG, EY and Deloitte, it still compromised on independence and was a huge part of a major accounting scandal. The auditors at Arthur Andersen never made any judgment calls on how Enron were performing. David Duncan who was the partner of the audit team on Enron was fired in the allegation of destroying evidence and documents of Enron when he got to know that the US Securities were approaching (The Globe and Mail, 2018). According to another study, Arthur Andersen and Enron both deliberately categorized hundreds of millions as an increase in shareholders equity even though it did not have that money. They both worked together and Arthur Andersen not only destroyed physical documents but they also went on to destroyed documents from laptops and e-mails that they had sent to each other (Hg.org, 2018).

A former employee of Enron, Kevin Jolly gave an interview in 2002 to The Wall Street Journal, where he mentioned the relationship between Enron and Arthur Andersen employees:

"Andersen auditors and consultants were given permanent office space at Enron headquarters here and dressed business-casual like their Enron colleagues. They shared in office birthdays, frequented lunchtime parties in a nearby park and weekend fund-raisers for charities. They even went on Enron employees' ski trips to Beaver Creek, Colo. People just thought they were Enron employees,"

It was also noted that many former Arthur Andersen employees joined Enron later. (Journal, 2002).

Considering all these factors it is not hard to figure out that auditors' independence was broken in many areas in this scandal. Another conclusion of this case is that auditors sometimes are too afraid or shy to ask its big clients any questions as they are being paid a lot of money. On the other hand, they are also shy to ask questions to get more engagements from the clients such as consulting services or taxation services.

In another scandal discussed in the scandals section, the case of WorldCom in 2002. They had the same auditors, Arthur Andersen, this was another case where auditors' independence was breached as the auditors got too close to the client and starting ignoring their mistakes. The threats of familiarity and self-interest again proved out to be correct. WorldCom was an ever growing company in the 1990's and ever acquiring a lot of telecom companies in the industry. However when the dotcom bubble burst, it started to find alternative ways to show that the company was still doing fine. The management of the company started to find ways it could improve or rather increase their revenues. One solution that they came up with was to transfer $2.8 million from reserves to income in the financial statements. As before the dotcom bubble busted, WorldCom had acquired many firms and they needed time to find ways to run and manage these firms. However, the CEO Bernie Ebbers of that time, thought it was better to cook the books than to ask for more time. In all this the auditors stayed quiet and signed off the financial statements without giving a sign of worry. Many believe that audit independence was a crucial factor in the collapse of WorldCom, if they had not been loyal to the CEO and exposed any fraudulent entries in the books, they might have had gotten more time and somehow managed all these new acquisitions.

As it can be seen in both the Carillion case and the scandals of early 2000's, auditors' independence has played a very big role. In all cases self-interest or familiarity threats are quite obvious. These were just some examples that were already discussed in this paper, there are many more studies and examples of this question. As mentioned before, many academics believe that there is no relation between non-audit work and independence but considering these failures I think there is enough evidence to support the ban.

The audit fee cap and restricting some non-audit services is a positive step towards bringing stakeholders and general public's trust back. Even though there aren't much evidence to support the 70% cap on audit fees, it still has an indirect impact on auditors' independence. The third and final point from the Regulation that will be analysed is the rotation of audit firms.

6.1.3 Mandatory rotation

EU

In the green paper of 2010, the EU Commission addressed the issue of having the same auditor or audit firm for a long period effected the audit quality and auditors judgement. It stated that even though there was a rule of changing the main audit partners, there was still the threat of familiarity. In the Green book they suggested that there should be a time frame where a PIE had to change rotate both the key audit partners as well as the audit firm itself. On the other hand the Commission was aware of the fact that many believed that by changing audit firms there would be a lot of knowledge or information that would be lost. However, the Commission still believed that by applying this rule there would be lesser risk to auditors independence. The conclusion in the Green Paper was that they would look at the pros and cons for this rotation.

Out of the 700 responses from the Green Paper, the majority of the responses were against this rule. This included audit firms, investors and some academics, they were mostly worried about the knowledge that would be wasted.

Big four & SMP

The big four were especially against it as they believed that looking at the previous studies and evidence there was no evidence to support that it would benefit or improve independence. They further stated that previous studies show that mandatory rotation would have a negative impact on the quality of the audit rather than a positive. They supported this statement by stating that there would be loos of information and that rotation of partners should be enough.

On the other hand mid-tier and smaller audit firms also supported the big four by not agreeing to the rule. They also believed that this would have a negative impact and there would be increase in the cost.

Investors & Academics

The investors had mix views of this mandatory rotation rule. Some believed it would improve audit quality and help dealing with threat to auditor's independence whereas others disagreed. Some of the investors also stated that they were against and did not believe in mandatory audit but suggested that re-tendering of audit firms should be more often. Then there were those that suggested that instead of mandatory rotation, the process in which an audit firm in tendered and meetings between audit committees should be more transparent and there should be more shareholder involvement. Public authorities also had a mix view on this rule. Some believed that it would be beneficial whereas others suggested that the audit committees should step up and decide whether there was any need for rotation.

On the other hand, academics had strong points from both sides. Those that were in support of this law argued that rotating and setting a time limit for auditors would improve auditors' judgement as they would not have to give a bias decision in order to renew their audit engagements. They suggested that as there would be a maximum time the auditors would be freer and give their best calls as they would know that they can-not be reappointed. Another point in favour of the rule was that as the auditors would know another audit firm would take over after the, they would make sure that everything was done properly. Some academics believed that the mandatory rotation should be somewhere between 5 to 7 years, if not for all firms than at least for PIE's such as banks and insurance companies. To cover loss of knowledge, academics suggested that there should be some in between the old firm leaving and the new joining.

However, by looking at the theoretical and evidential research it was harder to prove the benefits of this rule. Academics that were against it argued that benefits for mandatory rotation were only obtained under very particular conditions. These conditions were in respect to the costs associated with rotation and the market position of the audit firms. Academic believed that if it was cheap to change auditors only than this rule would be beneficial apart from that they also stated that it should be a free market where things like audit firms reputation would not affect the decisions. Whereas some academics suggested that by having short tenure, auditors would be less motivated to detect frauds (Ec.europa.eu, 2018).

Practical evidence

In the final regulation published by the EU, they decided that there is a time period for auditors, the minimum is 1 year and the maximum is 10 years. After the maximum there needed to be a break for at least 4 years before the same audit firm could provide services. However they gave Member states the option that this maximum period may be extended up to 20 years if there were two signing off auditors on the audit engagement. For the statutory auditors the legislation said that they need to be replaced after maximum 7 years and could not be on the same audit for another 3 years. Again giving member states the option but only for reducing these 7 years, if there was any need for it.

Now analysing the empirical evidence, there is much debate about this regulation. There are numerous studies that argue for it and against it. According to an article published in 2018 by the International Federation of Accountants, mandatory rotation had both negative and positive effect on independence. Positive facts included that by rotating auditors they would never get the chance to get too close to their clients. By getting too close to their clients there is a risk that the auditors may not think sceptically and work for the favour of the client hence they argued that the overall audit quality would improve. On the other hand there were those that argued that due to rotation there would be a lot of knowledge loss. They stated that every time an audit firm got rotated, all the knowledge it gained about the company would be wasted. Another point raised in this article was that auditors' physiological trust on the clients also plays a big part. Audited firms feel that audit firms and themselves build trust over time. These firms feel that once the trust is build it would improve the quality of the audit but by rotating the may never fully trust each other. However there are two problems with this point. The first one is the auditors and client trust each too much, the auditors may oversee some information just because they trust each other. The second is that by building a trust auditors might be in a better position to figure out any fraud as in the longer run auditors would be able to understand and be able to gain more confidence in judging the correctness of their clients. Those who argue against this law use this as support and claim that by changing auditors they may not use their physiological awareness or support to figure out if their clients are speaking the truth or not. Therefore they conclude that auditors do not think more sceptical by rotation and there are more cons than pros (ifac.org, 2018).

Looking further at the cons of rotation, one can argue that by staying at one client for more years, the auditors knows exactly what they need and where they would get it from. There will be no wastage of time and the audit will run smoothly. This will not only stop wastage of time but indirectly also the cost of audit as the lesser time needed for auditing the lesser the cost will be (Smart Business Magazine, 2015).

On the other side, having the same auditors over a longer period may let them feel too confident and may lose objectivity. For example if an auditor has been testing operating expenses over some years, he may be reluctant to change the way he has been testing them even though there may be more critical ways (Smart Business Magazine, 2015). Therefore it is very important to draw the line as rotation may go both ways.

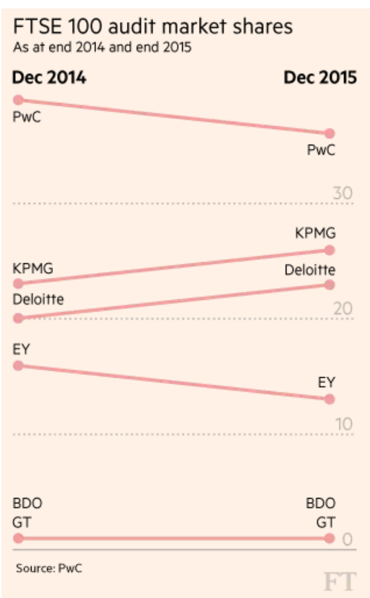
Another factor is that the new audit firm that takes over the audit engagement will require a lot of time to understand the industry and company. They will also need to understand the work done by the previous auditors. The cost and time spent on this task will also be charged to the client making the audit fees higher than before. Therefore the burden will not only be on auditors but also on the client in form of higher fees.

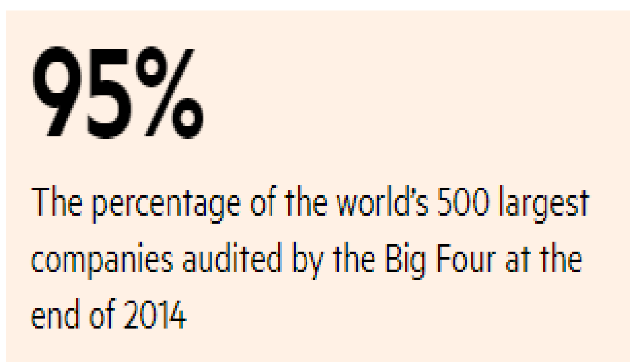
There are also studies that state that 10 years is too long for rotation. They believe that the damage may be done within 10 years and this rotation process should be shortened. This statement was based on a research where the data of 3465 companies were analysed to see if new auditors caught misstatements quicker than older auditors. In this analysis it was proven that new auditors had more misstatements by almost 50% (singer and Zhnag, 2018).

While there are more pros and cons of audit rotation, they goes around almost the same points as mentioned above. Therefore audit rotation will be looked at from another perspective. As the motive of the EU with mandatory firm rotation was to break the relation between the client and auditors for them to stay independent, in the UK they have found another problem to this. Even though the competition has increased but on the other hand the companies just flow around the big four. As mentioned in the previous section, in the UK the big four captures 97% of the audit of FTSE100 companies. According to PwC UK:

"What's happening is doing nothing for choice in the market. As one Big Four firm loses an audit mandate, another Big Four firm gets it"

They further state an example where PwC lost their client to EY, KPMG lost it to PwC, Deloitte losing to KPMG (Ft.com, 2016).





(Image source: PwC)

The picture above may not help to achieve the goal of the regulation. This shows that even though audit firms are changing, auditors may still have good relations with the clients as they just goes around a circle, ending up to the same auditors. This trend may also harm the overall competition in the market over time, as other audit firms may start ignoring these firms as they will not have hope of getting them.

Looking at the brighter side of this, Barclays, the second largest bank in the UK broke their 120 years old relation in 2014. PwC were their auditors since 1896 (Ft.com, 2016). So even though the competition may only be limited, it has brought competition between the big four.

Another study reveal that this rotation may harm the UK market as now that the big four has to rotate every 10 years, they may go to smaller PIE's that they wouldn't consider before. Before this rule they were sticking to their clients and targeting a specific group of PIE however due to this rotation, the big 4 may try to capture more and more clients (Fuller, 2016).

PwC states that there is not enough evidence to support that rotation will bring positive effects. Even though they agree with the goals of the EU Commission they disagree with the approach. They state that the audit quality and will affect the audit committee's ability to secure its responsibilities. They also state that such rotation will increase costs and reduce competition as seen in the example above. On the other side they came up with other measures that could be used. PwC states that by strengthening the communication between the committee and auditors would be more effective. On top of them they believe there should be more transparency where the public gets more involved, such as letting the public know the performance of the auditors, the basis of appointment or re-appointment and other main information or risks (PwC.com, 2013).

As it can be seen there are a lot of arguments for and against this restriction. On one side there is safeguarding the threat of familiarity and on the other hand there is the problem of loss of knowledge and as seen in the UK, problem of competition. The EU Commission left the date for this restriction on the member states and not all member states started with this at the same time. Therefore to consider whether audit rotation has had any effects on independence yet can-not be backed with empirical evidence. To further look at it, the rotation rule will be analysed in respect to the previous scandals, where this restriction might have had an impact.

Parmalat scandal, Italy (2003)

As discussed earlier, the Parmalat's case was also about covering the losing they were making. Parmalat is an Italian multinational company that deals with food and dairy products. They started the company in 1961 and saw huge success over the years. However in the 1990's the company started to fall short of sales and started making losses and the CEO of that time, Carlisto Tanzi, decided to manipulate their financial statements to cover these losses. As mentioned in the scandal section, they started to inflate their income by creating fake transactions. On top of that they took loans from banks using the same fake transactions as receivables. On the basis of these receivables they inflated their assets, and hid their debts from investors by moving the debt to equity. Due to this their balance sheet went in "minus" as their assets were inflated and debts were understated. This whole process continued for 13 years and Grant Thornton were their auditors over this period. In this period the CEO had influenced their auditors to work with him. However in 1999. Parmalat changed their auditors to Deloitte. The fraud continued even under new auditors as almost 49% of Parmalat's assets and 30% of revenue were held under subsidiaries. Parmalat only changed their own auditors and not for their subsidiaries, they were still being audited by Grant Thornton. It was only in 2003 that Deloitte published a report where they were unable to verify some investments that Parmalat had further exposing them completely.

In the above case it can be seen that mandatory rotation did help to expose a major accounting scandal. If we look back, the scandal may have been exposed 1999 if there was a rule that firms needs to change their auditors not only for the parent company but also its subsidiaries and network. Deloitte were unable to catch the fraud any sooner as they were relying on information from Grant Thornton who were totally influenced by the CEO. They both breached the rules of independence and did the jobs for self-interest. This fraud may have continued for longer time if Deloitte did not get suspicion on a gain from an investment and had they not further investigated it. PwC Italy did another analysis on Parmalat where they discovered that they were actually losing money since 1990, and in those 13 years, they were in loss for about 12 years (Financial Scandals, 2004)

According to an article published by The Financial Time, the CEO, Mr. Tanzi, enjoyed a very rich life standard where he would usually travel the world with his jet provided by the company and he was involved with many presidents of different countries, where Parmalat were operating. These were also reasons for he had influence over his auditors as they saw his life style and compromised over their work in order to improve their own living standards. The auditors chose self-interest over their duties. By the time this scandal was over, many crucial leaders of Parmalat were arrested and charged for fraudulent activities, including Carlisto Tanzi (Ft.com, 2008).

The new regulation has covered this problem that caused the Parmalat scandal. As mentioned earlier, the new regulation states that rotation applies not only to the parent company but also to its undertaking companies and any network company. This part of the rule is crucial as in the case of Parmalat, this was the crucial factor that led the fraud to continue.

Considering the above cases, pros and cons of audit rotation, it can be concluded that even though most of the audit firms this rule will have more negative impact than positive, I disagree to this. The reasons for disagreement are that there may be knowledge spillage but over the time this rule has been followed, audit firms will get used to follow and apply this concept. The risk for not applying this rule is too big and not justifiable by loss of knowledge. Even though there is not any empirical evidence to support this, looking at the Parmalat case, I feel the EU Commission has taken the right step forward to increase auditors' independence, stakeholder trust and improve the audit quality. Even though there are some points, mentioned below, that I disagree to, but looking at it generally, it is a step in the right direction.

For mandatory firm rotation, it can be argued that the EU Commission allow Member States to choose themselves for extension up to 20 years. In my opinion, the EU Commission should have a time frame that needs to be followed, and 10 years seems to be the perfect solution. 20 years may be too long and a lot of damage can be done in those years, it may be too late for the new auditors to discovery the activities going on. This is supported by the case of Parmalat where the same auditors continued for almost 13 years. Secondly, in the case of the UK market where the big four are rotating the clients in between them, I feel the UK Commission should have tighter laws for them. They should ensure that it’s not the same audit engagement team that joins the audit, as there are cases where employees stays at the same firm for more than 25 years. The after effects of Carillion, led to talks about breaking the big four in the UK into smaller companies, I don’t believe this is the most efficient solution, the Committee should rather focus more on the French system, where two smaller firms audit bigger corporation. I feel the UK may apply this concept on bigger firms, such as EY and PwC could audit together, this will improve quality of the audit as they will cross check each other. Apart from that it may also motivate them to show better performances as even though they are working together on this one client, they are competing with each other in the market.

Although there are some disagreements on mandatory rotation, all three restrictions capped audit fee, prohibition of NAS and mandatory firm rotation will help to take auditing the right way. There are many arguments against it but I feel the comparative loss that has been caused before the regulation is too big to suffer again. Therefore to sacrifice some things to get to the better cause is justified in my opinion.

7.0 Conclusion

In this thesis the main question was how auditors' independence could be saved from and threats and whether the current framework was enough.

The question in this thesis was answered based on the objectives set in the problem statement:

- To identify the factors / non-audit services that pose a threat to auditor objectivity
- To consider the current laws there are for protecting against such risks.
- To look at the previous failures of auditor's independence and see what affect it had on the corporate world as well as the whole accounting profession.
- To recommend ways through which the threats to auditor objectivity can be mitigated to an acceptable level

Due to previous major accounting scandals, the EU Commission issued updated laws in 2014. These laws were to enhance and improve auditors' independence. These rules were also established to improve the overall quality of the audit work. The rules were established on the basis of ISA and Ethics code, the auditors duty being to make sure that the financial statements were showing a fair and true value of the company.

Auditors' independence was explained through the use of of principal agent theory. Through this theory the importance of auditors independence is underlined by describing the problems associated with this theory. Principal agent theory describes the problem of when one party contracts another to perform a task they can't perform. This theory presumes all the parties involved are motivated to work for their personal gains and interest. Therefore to overcome this theory auditors have to be fully independent in appearance and the way they think. Auditors needs to get motivated by their duty that is to verify that the financial statements show the true and fair position of the company. Auditors also needs to be aware of the different risks that are mentioned in this thesis.

For the auditors to be independent and safeguarded from the threats to independence, the EU Commission issued a new regulation in 2014. This regulation is for all Member states and for some points, the EU also allows Member states to put more restrictions. The new rules have made some changes and brought some positives points to help overcome the problem of being dependent. The major points discussed being; fee cap on NAS, mandatory rotation and restriction on some NAS.

As these laws were fairly new and not all states applied the same year, previous scandals and theoretical work has been used to check whether they had any impact. From the literature review it could be concluded that many had mixed reviews. Some academic meant that auditors' independence was not affected by providing non-audit services and there was no empirical evidence to prove whereas some believed that it did have an impact. Further by analysing the previous accounting scandals a clearer picture was seen but it could not directly be related with the new rules as no specific country was chosen.

From the three analysed changes in the EU Regulation, positive relation were found by comparing it to the previous scandals.

Fee cap and restrictions on NAS

This law was created by the EU Commission in order to overcome the threat of self-interest. The EU were concerned that the audit firms may get too involved by providing non-audit services. By getting too involved in a company the auditors might working for their own benefit instead of doing their duty leading to breaching the independence. Another issue for the EU was that auditors might compromise on independence just to obtain non-audit services from the clients. Audit firms generally earn more from non-audit services than audit services. This also brought the risk of auditors offering low price audit service to gain non-audit services. Therefore, the EU set up the rule of fee cap on non-audit services. This rule stated that the fees for non-audit services were to be capped to 70% of the audit services, every third year. Other mentioned non-audit services were totally restricted for PIE and an audit firm could not perform these.

There were certain benefits as well as drawbacks of this restriction. Considering the big 4 view on this they were sure that this would not benefit or improve the audit quality as there would a lot of talent and expertise that would be wasted. They stated that audit firms had the expertise to perform non-audit service efficiently. Another point they raised was that they felt there were enough laws on independence and there was not any need for further laws. On the other side the smaller audit firms consisted that these restrictions should only be applied on PIE's, as they needed to provide such services in order to survive.

In the analysis, previous accounting scandals were analyzed in respect to these laws and to answer the third point of the objective of this thesis, previous scandals were analysed in respect to the new laws.

Three scandals were analysed; Enron, WorldCom and Carillion. In all three of these cases, it could be seen that self-interest of the auditors caused them to breach independence. Non-audit services could not be linked directly to these scandals, as there was no specification that by offering non-audit services that these audit firms got too involved. However, by considering that the risk of self-interest is associated with proving non-audit services, the link could be argued. Apart from that the arguments against this restriction were too weak to be considered, having in mind the previous scandals and their after effects.

Mandatory firm rotation

For the mandatory firm rotation the EU created this rule to overcome the problem of auditors getting too involved with the audit client. The EU were concerned that by having a long term relation with the client the auditors might compromise with their judgement. The EU were also concerned about auditors not performing their duty up their level as they would have a good relation with their client. For example, if an audit firm has had a client for 10 years, they may not be bothered to ask the harder questions any more as they are too close to the client. Another factor was that by doing the same job for such a long time they may get used to doing the same way, not considering if there are any better and more efficient ways of doing it. The EU decided that only would the audit firm change but also the audit partners. The audit firm has a maximum of 10 years, without considering any extension and the audit partners must change every 7 years. The EU stated by doing this they were safeguarding any threats to auditors independence, this could be threat of familiarity etc. This rotation also applied on any undertaking company, subsidiary or network company.

Again, there were some arguments for this restriction and some against it. Generally the big 4 and other audit firms were against this restriction, they believed that this would harm the audit quality more than improving it. The big 4 were concerned about the knowledge that would be wasted in the rotation process. They stated that by rotation, the knowledge and information that the audit firm had of their client over the time, would go to waste and not only time would be wasted but it would be a costly process. The SMP’s also agreed to the big 4 on the cost point claiming that it would be too costly for them hence they would loose more clients.

In the analysis some pros and cons were analysed of this restriction. The biggest argument for this restriction was that by applying this rule the auditors would not get not too close and this would safeguard their professional judgement and scepticism. Not only would this eliminate the threat of familiarity but also make the audit firms to work better as they would have a pressure of the next auditing firm. Due to this pressure, the audit quality may improve. This restriction would also safeguard the auditors independent thinking and by bringing fresh thinking, the risk of losing objectivity would be safeguarded. On the other side when it came to cons. As mentioned before, many audit firms and academics believed there would be a lot of knowledge that would be lost. Every time a new audit firm would be hired, they would waste of a lot of time understanding the company and the industry. For smaller firm, be wasting more time on the start would prolong the audit process, making them charge more money than they should. There were numerous pros and cons for this restriction without any empirical evidence.

Further in the analysis, this restriction was applied to previous accounting scandals to see whether it would have had any impact. One of scandals discussed in this thesis could be related to this restriction, the case of Parmalat in 2003. By analysing this restriction with the case the result showed that somehow this case might have been different if these laws existed. Parmalat had the same auditors under the years they were doing fraudulent activities. Grant Thornton were the auditors for Parmalet, and in 1990 they started doing unethical activities which continued for the next 13 years. Even though Parmalat changed their auditors in 1999 to Deloitte, this fraud still continued for the next couple of years. This was done as back then there was no rule about rotating auditors for subsidiaries and network companies. This let Parmalat continue the fraud in their subsidiaries and network companies that were still being audited by Grant Thornton. As Deloitte were relaying on the results received from Grant Thornton and Parmalat had almost 49% of their assets and 30% of their revenue coming from subsidiaries and network companies, they continued enjoying the fraud. Eventually Deloitte disagreed to sign an audit report in 2003 as they could not trace back some investments coming from their network companies. Now considering this case, the new restriction would have helped getting this scandal expose much faster. As according to the new rule, Parmalat would not only change their auditors in 1999 but also the auditors of their network and subsidiaries. Let’s assume that Deloitte were hired for their network companies then they would have exposed this whole scandal in 1999, reducing the loss. One may argue that the scandal would still have been taking place for almost 10 years but at least the exposure would have been faster than it was. On the other side another argument could be that if Parmalat had to rotate, they may not have done such activities in the first place, as they would know they would have been caught eventually.

To answer the fourth point and final point of the objectives of this thesis, considering the changes and current laws, most of the loopholes are covered by the EU. Not only do I agree with the restrictions they have made but they have also been applied to previous scandals to see how they might have changed the story. The restrictions and fee cap on NAS, I agree with the EU and feel that this would bring a positive change in the audit world but the EU should consider to make a clearer list of non-audit services that an audit firm may provide.

For the mandatory rotation I feel the EU should be stricter. The EU gives Member States the opportunity to extent the audit tenure, however I feel there should a specific timeframe from the EU that should be applied to all Member States.

Apart from some disagreements, generally this thesis is in support of the new restrictions and believes in the laws to secure higher level of independence. This has been supported by considering the previous major accounting scandals.

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