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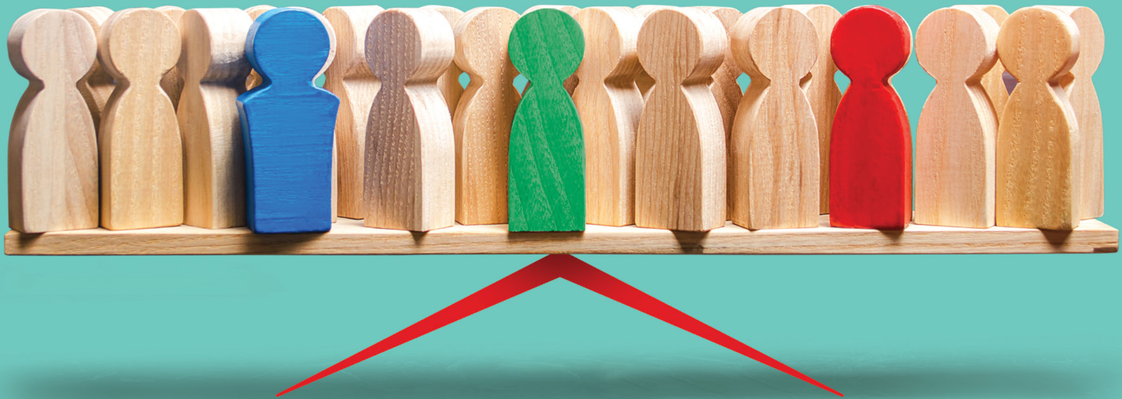

EU AUDIT REFORMS: ANALYSING DIFFERENT IMPACTS IN THE UK AND ITALY

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Contents

	Acknowledgements	2
	About the authors	2
	Executive summary	3
1.	Introduction	6
2.	The EU Audit Directive 2014 (implemented in 2016)	9
3.	Differential impacts of the EU Audit Directive on UK and Italian auditors	11
	3.1 Impacts of extended audit reports	11
	3.2 Mandatory rotation of audit firm and audit partner	13
	3.3 Impacts of the restrictions and caps on non-audit services (NAS)	15
4.	Conclusions	17
5.	Key References	19

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Executive summary

MOTIVATION FOR THIS STUDY

Evidence has been limited on the impacts of the 2014 EU Audit Directive (implemented in 2016) on European auditors, especially with respect to the regulatory, economic, and cultural differences among European countries. Four years after its implementation, it is considered timely to report on the impacts of the 2014 EU Audit Directive. This is one of the first studies providing clarity on the direct consequences of the 2014 EU Audit Directive for auditors and other participants in the audit and assurance market using a comparative perspective. The United Kingdom (UK) and Italy are purposively selected as representing two very different institutional settings, offering insights on how the efforts at standardising audit regulation may lead to very different organisational firm responses within Europe. For instance, in the UK, the corporate governance system is characterised by a relatively high degree of separation between ownership and control. The Italian corporate governance system, in contrast, has unique features that make it different from any other national systems in Europe. This is mainly the consequence of Italy having an under-developed stock exchange, with few publicly listed companies. The comparison of different institutional settings is deemed to be useful for gaining a better understanding of issues such as the standardisation/harmonisation of auditing standards and of auditing practices. The aim of the project is to undertake a comparative analysis of how the most recent EU audit reforms (implemented since 2016) have impacted external financial statement auditors in the market for audit and assurance services in both the UK and Italy.

THE SCOPE OF THIS STUDY

To arrive at its conclusions, the underlying methodology used in this study is essentially qualitative. We used focus groups and interviews in major business cities and regional centres such as London, Edinburgh, Milan, Rome, and Verona, to capture as wide a range of relevant opinions as possible from large and small audit practitioners and other stakeholders such as regulators, standard setters, audit committee members, investors, and professional bodies. Speaking with auditors enabled the authors to understand the underlying arguments, approaches, opinions, and procedures related to the issues under investigation. The relevant findings from this study for policymakers, regulators, and audit practitioners, regarding the impacts of regulatory changes in these two different institutional contexts, will assist with contrasting the implications from the EU Audit Directive (2014) under different institutional settings, and therefore will contribute to the debate regarding regulatory reform of the European audit markets.

KEY FINDINGS AND CONCLUSIONS

Both the UK and Italy have implemented the extended audit report (although from different points in time), and this reform has affected auditors differently from the UK and Italy. This is more the case in Italy, as the UK already had enhanced disclosures in their audit reports before the EU Audit Directive (2014). These differences can be summarised as follows.

In the UK, the extended audit report has entailed:

- increased accessibility to information on auditors' work and on professional scepticism;
- enhancing details on materiality judgements and threshold disclosures;
- new challenges in the interaction between auditors and company management; and
- some appreciation by financial analysts.

In Italy, it has fostered:

- increased task planning, quality controls, and verifications of the audit process;
- greater involvement of more senior or experienced auditors;
- increased interactions between auditors and audit clients at the executive level; and
- a lack of feedback or interest from financial analysts.

In relation to mandatory firm rotation, we observed differential impacts generally in both countries. For instance, in the UK, this is defined as quite radical, but a positive change, while it is 'nothing new' for Italy. In brief, observations on the impacts of mandatory rotations in the UK include:

- the advantage of having a 'fresh pair of eyes';
- increases in tendering costs; and
- increased time allocated to building more knowledge about a new client.

In Italy, instead, insights about the long-term experience with mandatory firm rotation include:

- confirmation of some positive effects on audit quality;
- continuous reduction of audit fees within tendering proposals to obtain the engagement; and
- increased frequency of auditors' activities to 'get to know' the new client.

In relation to the provision of non-audit services (NAS), the EU Audit Directive (2014) made little change in the UK. This was also true in Italy, where existing practices were already in place to deal with NAS restrictions or concerns. In both countries similar impacts of NAS restrictions are highlighted in this study with reference to mainly non-Big Four auditors. In the UK only, NAS restrictions and caps are seen to foster:

- prioritisation of NAS provision to larger companies if more lucrative than audits; and
- increased attention to auditor independence in view of the new tendering processes.

In both the UK and Italy, such restrictions are interpreted as providing more opportunities for non-Big Four auditors to sell NAS or audit services to new clients.

The ultimate and overarching conclusion of this report is that, after several successive EU Directives to regulate audit practices in the audit and assurance markets to harmonise these practices throughout the EU, the process of harmonisation remains difficult to achieve because of the significant differences that characterise European countries. Indeed, countries such as the UK and Italy have significant institutional and cultural differences that affect how such implementation of EU Directives takes place, and this study finds differences in how the latest EU audit reforms (implemented since 2016) have impacted these two very different European countries.

1. Introduction

Given the implementation in 2016 of the EU Audit Directive (2014) and its aim to support a harmonisation process of European auditing regulation, an understanding of the impacts of such reforms on auditors and their work practices is needed. Currently, there is very little research on audit firms' implementation of these EU audit reforms and how they affect auditor practice and overall performance. Field research is required to assess the results of changes in audit practices imposed by regulatory intervention, how these changes affect internal quality controls within audit firms, and whether such intervention ultimately leads to a more consistent audit quality level for these firms across countries.

Previous international studies on auditing practices have shown how past European reforms have been implemented with a significant degree of difference in the UK and Italy due to the relevant cultural differences among these countries (Stevenson, 2002). Both the UK and Italy responded to corporate collapses, accounting scandals and the Global Financial Crisis (GFC) by issuing new rules on corporate governance and audit, albeit by focusing on different mechanisms. The UK accountancy firms and the Financial Reporting Council (FRC) have faced renewed scrutiny from the investor public and the UK Government (CMA report, 2018; Kingman review, 2018; Brydon review, 2019). This has led to recent moves in the UK where the Big Four accounting firms must implement operational separation of their UK auditing and consulting practices by 2024 (Davis, 2020). Although the UK experience related to the EU audit reforms was somewhat positive until these recent developments (Kend and Basioudis, 2018), questions remain as to how it compares to other European countries, given the diversity of the EU requirements and the existence of member state options and interpretation issues (Kend and Basioudis, 2018). Like the UK, a few major corporate scandals and the eruption of the GFC occurred in Italy in the first decade of the 2000s (eg, Parmalat and Cirio), forcing Italy to revise its corporate governance and audit regime (Enriques and Volpin, 2007). Italy modified its long-standing provisions on mandatory audit firm rotation, renewable engagement terms, and cooling-off periods and introduced audit partner rotation. To such an end, the UK and Italy offer a suitable setting because they represent two contrasting models of European regulatory, economic and cultural background (Nobes, 1998).

The aim of the project is to undertake a comparative analysis of how the EU Audit Directive (2014) has impacted external financial statement auditors in the market for audit and assurance services in both the UK and Italy. Evidence is still limited on the impacts of these EU audit reforms on European auditors, especially with respect to the regulatory, economic and cultural differences among European countries. The comparison of two different institutional settings is deemed to be useful for policymakers and practitioners to gain a better understanding of issues such as the standardisation/harmonisation of auditing standards and of auditing practices. Hence, the broad objective of the study is to address the general research questions:

> **How do the impacts on auditors of the latest EU reforms to audit compare between the UK and Italy? And how have these EU reforms affected audit firms in both countries?**

To address these research questions, we compare the overall impacts of these reforms in the UK and Italy and consider the perceptions of both large and small audit practitioners in doing so. Focus groups and interviews were conducted in both major business cities and more regional centres, such as London, Edinburgh, Milan, Rome and Verona. Face-to-face semi-structured interviews were used for participants who could not join the allocated focus group times. We also used face-to-face interviews as a follow-up with some audit partners and senior audit managers/directors who participated in pilot testing during 2017. The focus groups and office interviews, each lasting approximately two hours, were conducted throughout the last six months of 2018 and first six months of 2019. When possible, focus groups and interviews were audio recorded to capture the detail of these discussions. In the two countries, in total 50 participants were involved during 2018 and 2019. To ensure quality control, at least two members of the research team participated at every focus group run or interview. Some pilot testing of the questions was undertaken during 2017 in both the UK and Italy, and this was primarily the method of refining the questions we asked participants. Thematic analysis was used to discover themes and draw conclusions. The data collected were coded to identify dominant themes within the stakeholder groups involved in this research. The dominant themes identified were compared to highlight similarities and differences between the two countries. Using NVIVO, 12 software textual patterns were identified from the interview transcriptions to detect trends and themes within the data that prompted certain conclusions. Table 1 provides the demographics of participants from the UK and Italy, where 10 of the 23 UK participants and 13 of the 27 Italian participants are audit partners. The respondents were predominately from London, Verona and Milan and had a wealth of experience in the accounting and auditing fields.

Table 1: Summary of participants by country, stakeholder groups, location, and years of experience.

	UK		ITALY	
STAKEHOLDER GROUPS	**YEARS OF EXPERIENCE**	**LOCATION**	**YEARS OF EXPERIENCE**	**LOCATION**
Regulators	>15yrs (3)	London (3)	>15yrs (1) >30yrs (3)	Rome (4)
Standard Setters	>30yrs (1)	London (1)	-	-
Big Four Audit Partners	>15yrs (6)	London (5) Edinburgh (1)	10–14yrs (3) >15yrs (3) >30yrs (2)	Milan (2) Verona (6)
Non-Big Four Audit Partners	>15yrs (4)	London (4)	10–14yrs (1) >15yrs (3) >30yrs (1)	Milan (3) Verona (2)
Audit Committee Members/BSA[1]	>30yrs (2)	London (2)	>15yrs (4) >30yrs (6)	Milan (5) Verona (5)
Investors	>15yrs (2)	London (2)	-	-
Chief Financial Officers	>30yrs (1)	Edinburgh (1)	-	-
Professional Body Members (staff)	10–14yrs (4)	London (3) Edinburgh (1)	-	-
Total by categories	*10–14yrs (4)* *>15yrs (15)* *>30yrs (4)*	*London (20)* *Edinburgh (3)*	*10–14yrs (4)* *>15yrs (11)* *>30yrs (12)*	*Rome (4)* *Milan (10)* *Verona (13)*
Total		**23**		**27**

[1] BSA refers to the Board of Statutory Auditors. These only exist within Italian corporate governance bodies. They are an independent board appointed by shareholders to supervise the board of directors and increase the minority shareholders' protection. They are responsible for ensuring compliance with regulations and bylaws, and the adoption of adequate management practices.

2. The EU Audit Directive 2014 (implemented in 2016)

According to a recent EU Parliamentary Report (2019), the EU Audit Directive (2014) came into being in the aftermath of the GFC. Its major aim was to strengthen confidence in the integrity of reported financial statements and improve audit quality. In achieving this goal, one of the main objectives of the EU Audit Directive (2014) was to make the top end of the audit market more dynamic (Horton et al, 2018). In the aftermath of the GFC, significant weaknesses were identified in the statutory audit function; and these weaknesses were cited as a factor in auditors failing to provide any warning signals about troubled banks (see eg, Humphrey, Loft and Woods, 2009). This strong criticism started to raise concerns about the accuracy of audited financial statements of large companies, and intensified issues around auditor independence (EU Parliament 2019). There are however a range of factors (such as close business relationships, long tenures, the joint provision of audit and non-audit services, etc) which constrained auditors from behaving in an independent manner. Regulatory intervention and indeed sanctions – including those relating to corporate governance – have been deemed necessary to ensure that auditors do carry out their work and make their judgements in an independent manner (Gwilliam and Marnet, 2015).

The key changes included in the European audit reforms (2014) were the extended audit report, bans, caps and restrictions on non-audit services, more powers for audit committees and mandatory firm rotation by auditors. The stricter requirements that apply to the statutory audit of public interest entities (PIEs), based on the implementation of the EU Audit Directive from 2016 are as follows.

- Strengthening the requirements of the audit report, and introducing an additional, more detailed report to the audit committee, containing thorough information about the performance of the audit.
- Introducing a maximum 10-year firm rotation with the option for member states to choose shorter periods (eg, Italy opted for 9-year mandatory audit firm rotation) for PIEs. A further 10 years can be added, up to a maximum of 20 years, where a public tendering process is conducted (ICAEW, 2016). For joint audit arrangements, a further 14 years is allowed, up to a maximum of 24 years (ICAEW, 2016).
- Establishing a list of non-audit services that cannot be provided by the statutory auditor or audit firm to the audited entity, as well as imposing limitations on the fees charged for non-audit services.

The extended audit report has been introduced by regulators with two aims. The first aim is to provide a real focus on the issues that are being addressed in the audit. The second aim is to have the auditors stating more information about the audit itself. In addition, the EU Audit Directive (2014) intends to address auditor independence concerns through the introduction of mandatory rotation which, at the general level, can entail: (1) mandatory partner rotation; and (2) mandatory audit firm rotation. Such changes aim at increasing audit quality and may impact auditors' organisational and managerial practices. Audit committees of PIEs assume a prominent direct role in the appointment of the statutory audit firm, as well as in the monitoring of the audit process (FRC 2007, 2009, 2010). They are now required to rotate auditors periodically, though the period may vary across member states. The general rule is that the auditors must be rotated at least every ten years. However, member states may choose to reduce this period to a shorter period or may also permit PIEs to continue with the incumbent auditor for a maximum of 20 years if a transparent tender procedure has taken place, or for a maximum of 24 years if there have been joint audits.

The EU Audit Directive (2014) also has introduced specific restrictions on a range of non-audit services (NAS) that PIEs in the EU can obtain from the audit firm and its network (eg, certain tax and legal services, bookkeeping and preparing financial statements, designing and implementing internal control or risk management procedures related to the preparation of financial information, and related technology systems). These types of restrictions related to NAS are not entirely new as the US had introduced prohibitions on a range of NAS provisions via the Sarbanes-Oxley Act of 2002 (US) some 14 years prior to the EU Audit Directive (2014). Finally, the EU audit reform requires the total fees from NAS to be limited to no more than 70% of the average of the fees paid in the last three consecutive financial years for the statutory audit of the client. These actions by the EU support the findings of a prior ICAEW report (Gwilliam, Marnet and Teng, 2014) that stated that 'in circumstances where the benefits of the joint provision of NAS to client companies cannot be unequivocally demonstrated, the logical regulatory response is likely to be to prohibit, or at the least significantly restrict, the joint supply of such services to audit clients'.

3. Differential impacts of the EU Audit Directive on UK and Italian auditors

In this section, we firstly discuss the impacts of the reforms on the extended audit reports, and then reveal insights on mandatory firm rotation and the provision of NAS.

3.1 IMPACTS OF EXTENDED AUDIT REPORTS

As a result of several UK reforms before the EU Audit Directive (2014), the UK has seen more pages in the audit report and more careful consideration of the wording of the audit report, which is no longer standardised. There is an acknowledgement in the UK that the extended audit report is now quite long. Mainly, the concerns raised in the UK were that, due to increased regulatory scrutiny, auditors' risk management systems and internal quality controls within audit firms had to be improved, and that this was a distraction from the audit process and reporting side. The findings from the UK also indicate that the extended audit reports are an improvement over the old form reports, mainly because of: (1) increased accessibility to information on the auditors' work; and (2) materiality threshold disclosures. The extended audit report has given external auditors a licence to think out of the box, be more creative, demonstrate scepticism, and to have more freedom to express how they reached their judgements. This greater transparency provides interesting evidence against enhancements promoting boilerplate disclosures by auditors.

> **'I know a lot of people who […] tell me that it [the extended audit report] has focused their minds. It has given them an element of creativity that they did not have before to say what they really think.' (BIG FOUR AUDITOR, LONDON).**

Consideration could be given to the ordering of the information that goes into the extended audit report, although this was not raised by many UK participants. The concept of an audit expectations gap suggests that society's view of the auditors' role is different from how auditors themselves view their true role to be (Koh and Woo, 1998). For instance, the Brydon Review (2019) identified fraud and auditors' related responsibilities as the most complex and misunderstood of all the topics covered by the review and the UK Government in response has since proposed a package of measures, including greater clarity regarding the respective roles of directors and auditors, to restore public confidence in auditors' work (Department for Business, Energy, and Industrial Strategy, 2021). Further, there is the audit expectations-performance gap, which is defined as the gap between society's expectations of auditors and auditors' perceived performance (Porter, 1993). Researchers are concerned with investigating the factors contributing to the audit expectations gap and proposing solutions to help narrow the gap. One might argue that the disclosure of materiality thresholds might help with the audit expectations gap problem, and better assist stakeholders to understand the concept of materiality (De Martinis and Burrowes, 1996). In the UK, materiality thresholds are disclosed in audit reports, whereas in Italy this is not the case. In the UK, materiality disclosures were generally seen in a positive light by the participants in this present study, as a reform that genuinely assists in narrowing the audit expectations gap. More disclosures of going concern work in the key audit matters section has also helped improve transparency in this respect according to the UK participants. Some UK participants indicated that – out of all the additional disclosures in audit reports – materiality thresholds and the related information were the single most important audit reform:

> **'If anything, that we have done over the last 30 years to help address the audit expectations gap, I think this [materiality disclosures] has done more for that than anything else up until this point in time.'** **(BIG FOUR AUDITOR, LONDON)**

In the UK, when we asked about the impacts on the auditors' relationship with clients, many of the participants indicated that the extended audit report has generally improved this relationship by better demonstrating: (1) the application of professional scepticism; and (2) the outcomes of an audit for company management. As the auditors are required to say a bit more about the audit than in the past, this has been perceived as an opportunity to provide more information and disclosure about the audit process to the outside world. The reform is perceived to have given auditors some more responsibilities to talk about the issues surrounding the audit in the report. Thus, as the Brydon review (2019) emphasised, there is a need for enhancing the informative content of the audit product. The audit report now better creates the opportunity for auditors to give financial statement users some sense of what the audit looks like in terms of scope. More disclosure on materiality thresholds and going concern work disclosed in the key audit matters (KAMs) section of the audit report has helped with narrowing the audit expectations gap. This behaviour is in line with the new requirements introduced by the revised auditing standard on 'Going Concern' ISA 570, which has increased the workload of auditors when assessing companies' going concern for accounting periods starting on or after 15 December 2019 (FRC, 2019).

If we move the focus now over to Italy, Italian Big Four auditors agree that the extended audit report EU reform has introduced a significant change for the organisation and the management of their audit activity after the reform was enforced in 2016. Like the UK, they have recognised how the length of the report has increased. From a two-page report, auditors are now preparing a six- to twelve-page report (on average). We can summarise the organisational impact on Italian auditors in terms of three main impacts: (1) the need to plan their auditing tasks more in advance; (2) the greater involvement of more senior or experienced auditors for quality controls throughout the auditing process; and (3) the incremental rise in the number of internal notes to document the audit process. This indicates that Italian auditors were more affected by the extension of the audit report than their UK counterparts, thus providing further evidence of how pronounced differences in audit practice are related to the audit report and its disclosures across different legislative jurisdictions within Europe.

Italian auditors show a general satisfaction regarding the extended audit report and how it has positively affected the market. Although auditors feared that, in view of the new audit report, the augmented disclosure would have exposed them to higher risks of being dismissed by clients or of lawsuits, they now recognise that the investors have appreciated the new form audit report. While previously, the audit report's primary readers went straight to the audit report's conclusions, the whole of this extended audit report has gained their attention for the first time, and they are reportedly reading the entire report with more attention:

> **'We [the auditors] always carry out the audit activity in the same way but we have changed the way we report it. […] this is positive because, even if the extended audit report requires us a greater effort, it allows us to better communicate now with third parties.'**
> **(BIG FOUR AUDITOR, VERONA)**

There is a sea change in Italy, with more work undertaken earlier in the audit, more communication with management above the CFO level, and more hours spent on the audit to verify what is going into the extended audit report. Appreciation of the higher transparency of the extended audit report was confirmed by the Italian regulators we interviewed. This greater transparency has led to a positive reaction by investors in both countries, although reactions from financial analysts have been more positively felt by the UK at this stage than Italy, based on our findings. Appreciation of the extended audit report by financial analysts and investors in the UK is somehow comforting compared to recent FRC reviews (CMA report, 2018). Auditors in Italy indicated that during the first year of implementation of the extended audit report, financial analysts did not show much appreciation or interest. Financial analysts in Italy had adopted a more cautionary approach, being the first year of implementation, which explains these observations shared by Italian auditors we interviewed. While Italian auditors seemed quite surprised by this reaction from financial analysts during the first year, they have since recognised that Italian financial analysts have now started to rely more on the extended audit report.

3.2 MANDATORY ROTATION OF AUDIT FIRM AND AUDIT PARTNER

Most UK participants agreed that having the same auditor for well over 20 years is not perceived well, and that the newly introduced audit firm rotation policy is assisting greatly in mitigating these concerns. The positive aspects that emerged from the interviews and focus groups on mandatory firm rotation in the UK centre around the elimination of concerns surrounding long tenures, and the advantages of having a 'fresh pair of eyes', or a new auditor with a 'rethink' or fresh perspective on the audit. The CMA report (2018) highlighted having new insights and challenges from a new auditor as benefits. Moreover, the mandatory firm rotation is a significant change, as it was suggested that it will have a more substantial impact than audit partner rotation, perhaps leading to a complete rethink of the whole audit process after many years of the same approach being adopted by the same audit firm:

> **'I think firm rotation is good in many ways. … I think there is a perception issue. I think that – whereas rotation of audit partners every five years was helpful, the truth of the matter is that it does not really create – or very rarely does it create – a radical rethink of the audit.'**
> **(AUDIT COMMITTEE CHAIR, LONDON)**

Among the UK participants, some negative impacts are indicated when referring to the new mandatory audit firm rotation from the EU audit reform (implemented since 2016). The main concerns were expressed around three main aspects: (1) the potential increase of the tendering costs; (2) the increase in the time taken to build the necessary experience with a new client; and (3) the sufficiency of existing regulation already provided by UK laws (prior to the EU audit reforms implemented in 2016), such as mandatory audit partner rotation.

With reference to the first and second aspects, views gathered suggest that UK participants are already forecasting what has already happened in Italy after 45 years of mandatory audit firm rotation. The implementation costs of audit firm rotation, such as the tendering process and the initial years of learning the processes and business of a new audit client, are predicted to

continue to increase in the UK. The learning curve costs are typically borne by the audit firms; however, these costs over time would be passed back onto the clients via audit fees, therefore increasing the costs of statutory audits to the wider society in general. Among several auditors' opinions on this point, the following are particularly relevant:

> **'The cost of tendering is huge in terms of the audit market here in the UK, like to get to know the strategy plans of a new client and then go through various standards and produce thorough documentation for a new client.'** (BIG FOUR AUDITOR, LONDON)

> **'Firms will be forced to incur the costs of participating in audit tenders that they may not have much chance of winning. Choices also need to be made about whether firms wish to provide audit or non-audit services to clients – choices that may be very difficult to change if circumstances later change.'** (CFO, EDINBURGH)

These issues related to high costs of tendering, especially the invariable costs of submitting either a winning or losing tender, which are likely to be similar, where the probability of success is relatively low, particularly for challenger firms, may put more weight to the CMA (2018) recommendation of joint or shared audits, if done outside the normal auditor rotation cycle. This remedy could improve resilience in the market by allowing smaller firms to grow and become more competitive in the tender process.

While, for the UK, the mandatory firm rotation constitutes a significant change in audit practice, Italy has been dealing with such a norm, as well as mandatory partner rotation, for quite a while. Indeed, from 1975, Italy has adopted the mandatory firm rotation of a nine-year period – and later a mandatory seven-year partner rotation (Corbella et al, 2015). As a result, it is not surprising that, in Italy, auditors indicate that the mandatory audit firm rotation from the EU audit reform has not entailed a real change. Participants in Italy indicated that they have long been used to more frequent tenders and their related timing considerations. They are convinced that the mandatory firm rotation requirement of the EU audit reforms is more of a 'trauma' for countries such as Germany and the UK, where auditors have been auditing the same companies for many years:

> **'[in] other countries like Germany and the United Kingdom where audited companies used to have the same auditor for 40 to 50 years; in these entities, there has been a real change in the business model, since, before the introduction of this new rule, an auditor would have provided a client with audit services up until retirement.'** (BIG FOUR AUDITOR, MILAN)

As indicated by Italian auditors, who have been dealing with mandatory firm rotation for decades, the tendering process as well as the management of cooling-off periods has been the norm, with no significant implications for their activities and organisational practices. This is confirmed also by audit committee/BSA members who in general indicated other EU audit reforms (ie, the extended audit report) as the real change in audit for Italy. However, due to a longer practice of mandatory audit firm rotation, Italian auditors, and audit committee/BSA members, were able to provide insights based on their longer experience about the long-term consequences of such practices. Italian auditors confirmed some benefits of the rotation system on audit quality, like the benefits from a 'fresh pair of eyes' over the audit engagement. However, they also indicated that such a system has entailed other consequences, such as: (1) continuous

reduction of audit fees; and (2) more frequent entry activities to 'get to know the new client'. Firstly, after every audit firm rotation, the audit fee is generally said to reduce, which generally assists success in the tendering process, while the continuous change in regulations requires additional effort that is not adequately remunerated by the audit and assurance market. This is a source of frustration for Italian auditors, as, typically, increased audit effort is accompanied by increased (and not decreased) audit fees. However, to have more success in the tendering process, they are sacrificing their audit fee margins. A 'loss-leading' practice is one in which auditors compete for clients by reducing their fees for statutory audits.

> **'Every time an auditor changes according to the firm rotation policy, our remuneration [audit fee] decreases by around 20-30%.'** **(BIG FOUR AUDITOR, VERONA)**

Secondly, the activities for new incoming auditors to 'get to know their clients' have become more frequent. Especially in large and complex international groups, such activities can be time consuming and costly for the audit firm, and a distraction from some parts of the audit process, based on the insights from Italian participants:

> **'The firm rotation mainly influences groups that are quite complicated. […] It takes auditors nearly two years or more to understand exactly where they are.'** **(BIG FOUR AUDITOR, VERONA)**

3.3 IMPACTS OF THE RESTRICTIONS AND CAPS ON NON-AUDIT SERVICES (NAS)

In the UK, the introduction of the restrictions on NAS have pushed audit firms to make strategic decisions and, in some cases, to prioritise the provisions of NAS to large companies rather than take on low margin or loss-making audits. Some PIEs are adopting the approach of using two of the Big Four firms for NAS and keeping a third firm relatively 'clean' in case they need to change auditors. This effectively means that a company has a choice of one (Big Four) when it needs to or wants to change auditors from the incumbent. While some audit firms are searching for the more lucrative NAS work as a priority to new audit work, clients are negotiating the fine balance of maintaining audit independence and having enough auditor choice when it comes to tendering. Some audits will be profitable and/or strategically important, so in some cases the provision of NAS is not necessarily the priority.

> **'You are starting to see already some Big Four firms are having to be bullied by big companies to compete for their audit tenders because they prefer to maintain their independence leading to the consulting work (NAS). I know of one big company, that had to tell one of the Big Four firms, "If you do not bid for our audit, we will never give you any further consulting work".'** **(BIG FOUR AUDITOR, LONDON)**

In both the UK and Italy, there is general agreement that the NAS reforms will create more opportunities for non-Big Four auditors to sell NAS or audit services to new clients due to the restrictions that the EU reforms impose. Some auditors in the UK have argued that it will be up to audit committees to decide whether they wish to be more associated with the smaller practitioners, whether this is for audit services or non-audit services. The 2018 CMA report

found that the average sales of NAS to audit clients appears to be slightly higher for the smaller firms than for the Big Four (in 2018). Some argue that, with future audit tenders in mind, smaller practitioners are being considered for new NAS work, to allow for relationship building. Audit tendering considerations are impacting the allocation of NAS work based on the views of the participants in the UK. In the UK there are limited instances of companies using the non-Big Four for other services to test the water in a build up to appointing them as auditor. In Italy we found that the non-Big Four auditors are building up skills in delivering prohibited NAS, that the Big Four incumbents cannot deliver. This was not observed in the UK.

> **'I think we have the smaller firms getting more non-audit work. As to whether that is because of the non-audit services ban and the fee cap I think is moot point because I think it is more to do with the "How can we get to know these firms for future tenders?".'**
> **(BIG FOUR AUDITOR, LONDON)**

In Italy, participating Big Four auditors recognise that being part of a multidisciplinary network is an advantage, because audit teams' specialists (eg, information technology, tax, risk management) help improve audit quality:

> **'Certain activities cannot be carried out on audit clients, but they [field specialists] can help maintain within the network those same competencies that, on the one hand, are useful to the audit team to perform a good work and, on the other hand, may be offered to the market as far as non-audit clients are concerned.' (BIG FOUR AUDITOR, MILAN)**

In Italy non-Big Four auditors aim at collaborating with Big Four auditors rather than competing directly. On several occasions, non-Big Four auditors admitted that they are making more and more effort to build and strengthen their competitiveness on NAS by leveraging their high specialisation. In this way, they aim to become the main, local service providers of audit clients of Big Four companies, as far as restricted or prohibited NAS are concerned. As a result, Italian auditors from non-Big Four firms indicate how they continuously develop advisory services related to tax and legal support, which are the main prohibited NAS activities. This is similar to what is happening in France in relation to the mandatory joint audit, which is providing non-Big Four firms with the opportunity to gather experience and expertise, make connections, and break into a market that is currently rather closed to the UK firms. This strategy is not yet adopted by the UK non-Big Four firms, representing an important point of difference. The CMA report (2018) indicated that when it came to tenders, some challenger firms were not considered to have the capability or 'global footprint', and thus were precluded from the invitation to tender. The solution then could be that Big Four and challenger firms arrange joint or shared audits which will assist in the sharing of fees in the UK and in the building of the expertise to acquire more experience for challenger firms.

4. Conclusions

Both the UK and Italy have implemented the extended audit report, and this reform has affected differently auditors from the UK and Italy. In Italy more so, the extended audit report has affected auditors' relationships with their audit clients and has led to significant changes in their organisational practices and in the management of their audit practices; whereas in the UK, the EU audit reform has not led to significant changes since 2016, as the UK already had enhanced disclosures in their audit reports. Related to mandatory firm rotation, we observed differential impacts in general in both countries: in the UK, this is defined as quite a radical change, although seen as positive; while it is 'nothing new' for Italy; and besides the overall positive experience, some negative perspectives were also shared by the Italian participants. Related to the provision of NAS, the EU reforms since 2016 made little change in the UK audit and assurance services market, as the Auditing Practices Board (APB)'s Ethical Standard 5 (ES5) in 2011 had introduced a requirement that audit committees consider the scale and nature of NAS provided to companies by their auditor (Gwilliam, Marnet and Teng, 2014). In addition, ES5 identifies specific NAS which present a threat to auditors' independence so significant that no safeguards are likely to reduce the threat(s) to audit independence to an acceptable level (Gwilliam, Marnet and Teng, 2014). The 2011 ES5 prohibitions in the UK (although not considered statutory restrictions) are not dissimilar to those prohibited in the US by the Sarbanes-Oxley Act of 2002. This is also the case in Italy, where existing practices were already in place to deal with NAS restrictions. However, both UK and Italian audit firms are considering NAS provision and EU restrictions when choosing strategically their participation in the tendering process of PIEs. A summary of the main impacts of the EU Audit Directive (2014) on auditors, their clients, and these two capital markets (the UK and Italy) is provided in Table 2 below.

Table 2: Summary of the main impacts of the EU Audit Directive (2014) on auditors, their clients, and on these two capital markets (the UK and Italy).

IMPACTS OF THE EXTENDED AUDIT REPORT (EAR)	
UK	• Improved audit report thanks to increased accessibility to information on the auditors' work and materiality threshold disclosures. • Freedom to express how professional scepticism is applied and judgements are reached. • Challenges in the interaction between auditors and company management. • Some appreciation of the audit report by financial analysts.
Italy	• Need to plan the auditing tasks more in advance. • Greater involvement of more senior or experienced auditors in quality controls throughout the audit process. • The incremental rise in the number of internal notes to document the audit process. • Initial concerns on possible exposure to lawsuits turned into an appreciation for information sharing about the auditor's role. • Increased number of executives with which the auditors now interact. • Lack of feedback, interest, or appreciation from financial analysts.
MANDATORY ROTATION OF AUDIT FIRMS AND AUDIT PARTNERS	
UK	• Views shared indicating firm rotation is quite a radical change for the UK. • Elimination of concerns surrounding long tenures with the incoming advantage of having a 'fresh pair of eyes'. • Potential increases in tendering costs. • Increased time necessary to build the necessary experience with a new audit client. • Sufficiency of the UK regulations prior to the implementation of the EU audit reforms in 2016, eg, related to mandatory audit partner rotation.
Italy	• Long-standing practices with positive effects on audit quality. • Continuous reduction of audit fees in tendering proposals to obtain the engagement. • Issues with the auditors' learning curve (ie, time to get to know the client) upon starting a new tenure.
IMPACTS OF THE RESTRICTIONS AND CAPS ON NON-AUDIT SERVICES (NAS)	
UK	• Strategic decisions to prioritise the provision of NAS to larger companies (when these are more lucrative than audits). • Clients' attempt to balance between auditor independence concerns and enough choice for the new tendering processes. • More opportunities for non-Big Four auditors to sell NAS or audit services to new clients.
Italy	• More opportunities for non-Big Four auditors to sell NAS or audit services to new clients. • Non-Big Four auditors committed to providing specialised advisory services related to taxation and legal support, which are the main prohibited NAS activities.

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