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Effects of the 2014 European reform on audit activity, the audit outcome and the audit market: the auditors' view

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Abstract

Purpose – This paper aims to examine the effects of the 2014 European regulatory reform on auditors' activity, the audit outcome and the audit market, with a focus on the Spanish market.

Design/methodology/approach – The research is based on in-depth, semistructured interviews with partners of the main audit firms operating in the Spanish market. This qualitative approach provides a precise identification of the cause-effect relationships of the new measures introduced by the European audit regulation.

Findings – The findings indicate that, based on auditors' opinions, the costs of the main regulatory changes outweigh the benefits. The European Union (EU) Audit Regulation imposes more demanding provisions, such as an extended auditor's report, mandatory audit firm rotation, more banned nonaudit services and stricter quality controls, resulting in substantial side effects on audit activity and the audit market. This could undermine the objective of enhancing the quality of audit services.

Originality/value – To the best of the authors' knowledge, this is the first study to analyze the effect of the 2014 EU regulatory reform on audit activity, audit market and audit outcome based on auditors' perceptions. The findings may be of interest to academics, professionals and regulators alike, as they offer valuable insights for assessing the effectiveness of the new audit provisions. Additionally, the qualitative methodology used facilitates a causal analysis of the key elements introduced by the regulations, potentially paving the way for future research avenues.

Keywords Audit regulation, Audit quality, Auditors' view, Effects of audit regulation, Audit market

Paper type Research paper

1. Introduction

The European Union (EU) has completed its audit regulation reform with the passing of Directive 2014/56/EU on the legal audit of financial statements [EP (European Parliament), 2014a, 2014b] and Regulation 2014/537/EU on the specific requirements for the legal audit of

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public interest entities (PIE) [EP (European Parliament), 2014a, 2014b]. Once implemented into the national legal systems of EU members, both the Directive and the Regulation have been in effect since June 17, 2016.

This is arguably the most important reform of audit regulation in the EU's history. It introduces new provisions, such as the mandatory rotation of the audit firm and the extended auditor's report, and reinforces existing ones, such as the prohibition of joint provision of audit services and most nonaudit services (NAS) by the statutory auditor [EP (European Parliament), 2014a, 2014b]. The aim is to enhance auditor independence, increase the transparency of the audit process and improve competitiveness in the audit market, with the ultimate goal of enhancing the quality of audit services [EP (European Parliament), 2014a, 2014b]. However, the accomplishment of its objectives has yet to be investigated. Additionally, as pointed out by Castillo-Merino *et al.* (2020), regulators did not appear to fully consider extant research evidence at the European level when implementing new provisions, as much of it refutes any association between audit quality and factors banned by the new provisions, such as long auditor tenure or the joint provision of audit and some NAS.

Many of the provisions are quite controversial because they seem to come at a cost for audit firms. The lack of consensus among regulators, practitioners and academics regarding the adequacy of the regulation raises questions about whether the regulatory change in the EU is more focused on enhancing the perception of auditor independence rather than improving factual audit quality, as has been the case with previous regulations, such as the disclosure of NAS types (Dopuch *et al.*, 2003) or the mandatory rotation of the engagement partner (Kaplan and Mauldin, 2008).

In this regard, this paper analyzes the influence of the main provisions of the regulation on audit activity in the Spanish market. More specifically, we focus on examining the extent of the related costs and benefits for auditors, audit outcomes and the audit market. The provisions include an expanded version of the auditor's report, mandatory audit firm rotation, stricter restrictions on the joint provision of audit services and most NASs, a requirement for internal quality control systems and improved oversight procedures. We also evaluate whether the regulation is achieving its goal of extending competition in the audit market and facilitating the access of new players. Spain is a compelling setting for this analysis because it is considered a country with low litigation risk (Ruiz-Barbadillo *et al.*, 2004). It belongs to the French civil-law region (La Porta *et al.*, 1998), which is known for relatively weak investor protection and corporate governance mechanisms. Lower litigation risk and weaker enforcement mechanisms in Spain compared to other EU countries may impact the effectiveness of audit regulations (Carrera *et al.*, 2007), particularly when there is limited public oversight and monitoring activity. As a result, it is reasonable to expect that the effect of tightening regulation may be perceived more acutely by Spanish auditors than by their European counterparts, and, therefore, any side effects may be more clearly observed in this environment.

This study contributes to a deeper analysis of the assessment of the EU audit regulation. To the best of our knowledge, this is the first paper to focus on auditors' perception of the consequences of the EU reform. Most previous research on the association between new regulatory provisions and audit quality has used quantitative methodologies based on the statistical analysis of archival data. For instance, Cabal-García *et al.* (2019) examined the effect of the reforms of the Spanish auditing regulation (2002, 2010 and 2015) on several proxies of audit quality. Their results indicate that none of the reforms had a significant effect on financial reporting quality, which the authors attribute to weak enforcement by Spanish institutions and call for further in-depth research. In contrast, we use a qualitative approach, which provides a more precise identification of cause-effect relationships of the

regulatory measures. The qualitative methodology has been previously used in the audit field (Gendron, 2009; Borgato and Marchini, 2021; Soares Fontes *et al.*, 2021). Sormunen (2014) points out, following other authors, the advantages of a qualitative design compared to quantitative research, when seeking to understand the context of a situation. Following this approach, our study is based on in-depth interviews with 14 audit partners from the leading audit firms operating in the Spanish market. These interviews enable us to capture auditors' perceptions of the effects of the EU reform on several dimensions of the audit professional practice, as well as on the audit outcome and the audit market.

Our results show that, in general, auditors consider the costs of regulatory changes to outweigh the benefits. Specifically, concerning the extended version of the auditor's report, auditors appear to standardize the report as a means of mitigating their perception of higher exposure and increased liabilities resulting from its expanded content.

Additionally, the new regime of mandatory audit firm rotation is not leading to an increase in competition in the PIE's segment of the audit market. Big 4 companies are being replaced by other Big 4 firms when they rotate, and, as a result, there are not enough incentives to foster joint audit contracts. Auditors also perceive mandatory rotation as a source of increased costs for audit firms, as they need to retrain and upskill staff. These costs are not outweighed by benefits in terms of the quality of the audit service.

There is a general agreement among auditors that the prohibition of joint provision of audit and many NAS is preventing knowledge spillovers between audit and NAS units. However, at the same time, it is perceived as an opportunity for non-Big 4 audit firms to enter the PIE segment.

The heightened demand for quality control and the strengthening of supervision systems are seen as an excessive burden for small audit firms. This segment of firms is less capable to bear the costs associated with a more demanding regulatory environment, leading to a concentration process in the Spanish audit market. Additionally, the increase in inspections by public supervisory authorities is perceived as having a clear positive effect, given its impact on the accuracy and quality of the audit service. However, the current approach to the inspection process is limiting the beneficial influence of the oversight activity on audit quality.

The paper continues as follows: Section 2 presents the theoretical framework, including a summary of the EU and Spanish audit reform, and a review of the literature on the relationship between the regulatory changes examined in this paper and their impact on auditors' activity, audit quality and audit market. Section 3 outlines the research design and the methodology. In Section 4, the results are discussed, while Section 5 draws the main conclusions, implications and limitations of the study, along with potential avenues for future research.

2. Literature review and hypotheses development

In this section, we outline the key provisions established by both the European and Spanish audit regulations, and review previous studies that delve into these matters.

2.1 Audit reform in the European Union and Spain

In the EU, audit regulation, originally governed by Directive 84/253/EEC [EEC (Economic European Community), 1984], underwent significant revisions following the US Sarbanes–Oxley Act (SOX, 2002) and a 2002 European Commission recommendation [EC (European Commission), 2002]. European Directive 2006/43/EC [EC (European Commission), 2006] resulted from these developments, aiming to harmonize statutory audit requirements across the EU. The 2006 Directive introduced changes such as updating educational qualifications,

defining professional ethics, applying international auditing standards and enhancing safeguards for auditor independence.

The financial crisis of 2007 raised additional concerns about auditor independence and audit quality, leading to the issuance of the Green Paper on Audit Policy [EC (European Commission) 2010]. In response, the 2014 Directive [EP (European Parliament), 2014a, 2014b] and 2014 Regulation [EP (European Parliament), 2014a, 2014b] for the legal audit of PIEs were enacted, with the goal of restoring trust in financial information.

In Spain, these regulations are outlined in the Audit Law 22/2015 (LAC, "Ley de Auditoría de Cuentas" in Spanish). The key changes introduced by the European Directive, Regulation and LAC include modifications to the auditor's report, mandatory audit firm rotation, stricter limitations on NAS and new requirements for internal quality controls. Notably, the revised auditor's report incorporates key audit matters (KAM), which describes the most significant audit risks and details how audit procedures address these risks (Gutierrez *et al.*, 2018; Porumb *et al.*, 2021). The European Regulation (Article 10), and Spanish LAC (articles 5 and 35), stipulate that the report must provide "the description of the most significant risks of material misstatement (RMM), including those due to fraud, a summary of the auditor's responses to these risks and, if applicable, key observations regarding these risks." Moreover, the auditor's report must contain a statement of independence and confirmation that no prohibited NAS were provided, alongside a paragraph on going concern. Additionally, auditors are required to explain the extent to which the statutory audit can detect irregularities, including fraud, and to disclose the appointment date and the number of consecutive years of engagement.

Noteworthy is the inclusion in the Spanish report of statements confirming no prohibited NAS and an emphasis on detecting fraudulent practices, which differ from European [EP (European Parliament), 2014a, 2014b] and international standards [IAASB (International Auditing and Assurance Standards Board), 2014, 2015a]. The International Auditing and Assurance Standards Board (IAASB), for example, decided that some elements of the auditor's report would be commonly required in all auditors' reports (IAASB, 2012), such as an explicit statement that the auditor is independent of the entity audited or statements describing both management's and auditor's responsibilities concerning the identification of material uncertainties [IAASB (International Auditing and Assurance Standards Board), 2014], while others could be tailored to meet national requirements.

The LAC also mandates a detailed auditor's report for all firms (Article 5), beyond the EU Regulation's requirement for PIEs. Additionally, it reinforces internal quality control mechanisms, adopting international standards. The authority of the Spanish Public Oversight Board (ICAC, *Instituto de Contabilidad y Auditoría de Cuentas*) is strengthened, with the ability to impose disciplinary measures and assess systemic risks.

To enhance competition, the new regulation facilitates the entry of audit firms into the Big 4 market niche and promotes mutual recognition of audit certificates across EU countries. The LAC includes the "European passport," allowing national audit firms to operate in other EU countries, fostering integration in the European audit market.

2.2 New auditor's report

In the EU, the auditor's report is regulated by the International Standard on Auditing (ISA) 700 "Forming the Opinion and Issuance of the Audit Report on Financial Statements," issued by the International Federation of Accountants (IFAC) through the IAASB and adopted by member states. This standard is supplemented by the provisions established in the 2014 Regulation (Article 10), and any additional requirements set forth by national regulations.

The revised version of the auditor's report has undergone a significant transformation from its previous highly standardized format, which was based on the notion that the primary objective of the report was to enhance the credibility of firms' financial information disclosed by managers, rather than providing new information or insights (Simnett and Huggins, 2015). While this approach was useful for comparing across firms, it failed to close the expectation gap between users and auditors, as users felt that the informative value of the audit report could be improved by clarifying the scope of the audit, the responsibilities of management and auditors, as well as by providing additional insights, such as the auditors' comments on matters to understand the audit or their opinions on value estimates made by managers (Vanstraelen *et al.*, 2012). The pre-ISA 700 audit report has been characterized by the use of generic and boilerplate language, providing little information to users (Lennox *et al.*, 2019) and exhibiting low levels of readability (Seebeck and Kaya, 2022). This generic model created expectations, information and communication gaps (Simnett and Huggins, 2015), which the IAASB aimed to address with the issuance of ISA 700 [IAASB (International Auditing and Assurance Standards Board), 2015a, 2015b]. The ISA 700 encourages auditors to provide further clarity on the different roles of the participants in the audit process (Simnett and Huggins, 2014) and to offer increased insights into the audit process. The standard emphasizes avoiding boilerplate wording and advocates for firm-specific KAM to inform about the auditor's judgments (Ong *et al.*, 2022).

The primary concern of the new version of the report is that increased disclosure might result in significant cost increases for auditors, both in terms of higher litigation risk and higher audit fees due to the need for more resources and time (Vanstraelen *et al.*, 2012; Simnett and Huggins, 2014; Seebeck and Kaya, 2022; Rousseau and Zhems, 2023; Burke *et al.*, 2023). Litigation against auditors increased over the past years under the pre-ISA 700 auditor's report (Willekens *et al.*, 1996; Chen *et al.*, 2005), indicating that compliance with audit standards is not a complete safeguard against allegations of negligence. The auditor's report has evolved accordingly over the years to minimize auditors' litigation risk (Gray *et al.*, 2011). In this context, the new reporting requirements may alter risk perceptions. It is unclear whether extended disclosure through KAM can act as an audit trail for potential misstatements or can be perceived more like a responsibility disclaimer in the event of potential litigation surrounding KAM disclosures (Kachelmeier *et al.*, 2020; Burke *et al.*, 2023; Ma *et al.*, 2023).

Empirical evidence is mixed. Gimbar *et al.* (2016) found that jurors view the use of KAM in the report as a reduction of auditors' constraints over financial reporting outcomes, which increases their liability. This perception leads auditors to increase audit work and include a litigation risk premium in their fees, and results in over-auditing or increased audit fees, or both. In the same vein, Backof *et al.* (2022) found that, in the absence of clarifying language of assurance reasonability, jurors tend to judge auditors more negligently when the audit report includes KAMs. However, some studies suggest that, under certain conditions, KAM disclosures can protect auditors from liability, for example, in cases of undetected misstatements (Brasel *et al.*, 2016).

To mitigate the adverse effects of litigation and operational costs, auditors may opt to standardize the language used in the different topics covered by the report (Gray *et al.*, 2011), through the development of standard KAM wording guidance (Rousseau and Zhems, 2023) or replicating peers' communication style by using publicly available reports of peer audit firms (Seebeck and Kaya, 2022). This could benefit comparisons across firms, but it could also lead to the creation of a new boilerplate language that would render the new sections in the report useless for financial statement users, as standardized wording does not convey firm-specific information (Seebeck and Kaya, 2022). These users prefer a short, readable and

easily interpretable audit report, which is not burdened with an excessive amount of information (Vanstraelen *et al.*, 2012).

The use of standardized KAM to alleviate auditors' litigation risk and decision effort may jeopardize the utility of the extended report. The results of prior research in this field are mixed. Several papers have shown that the new report is not conveying the expected information to users. Christensen *et al.* (2014), for instance, experimented with nonprofessional investors and found that KAM paragraphs focused on fair value estimates are informative and useful for decision-making, but only when managers have not adopted measures to mitigate the associated risks. Professional investors, however, do not use the information on fair value provided in the audit report through KAM because they use the details previously communicated in management's footnote disclosure (Riedl and Serafeim, 2011; Carver and Trinkle, 2017) reported that the disclosure of KAM negatively affects the readability of the report for users and does not provide investors with any additional information to make their valuation judgments. Lennox *et al.* (2019) took advantage of the entry into force of a new regulation in the UK and Ireland in 2013 requiring an expanded audit report, through the use of ISA 700 [1], to the largest companies of the London Stock Exchange (LSE) (companies included in the main market of the LSE), to analyze investors' reactions to the disclosure of the RMM in the report. Their findings suggest that the new report does not convey value-relevant information to investors because most of the RMM are previously reported by firms' management, and they are confident that any significant risk will be addressed during the audit. In addition, they found that 73.45% of KAM had already been reported by the auditor in the previous year. In this regard, Kend and Nguyen (2020) examined the new Australian auditing regulation on KAM and found that around 70% of Australian firms in their sample had the same KAM in the two years of analysis, 2017 and 2018.

Gutierrez *et al.* (2018) also analyzed a setting of the UK companies and failed to observe any significant effect of the regulatory change on investors' reactions to the disclosure of audit reports. Furthermore, since 2003, France imposed the obligation to include a justification of assessments in the auditor's report, focusing on the explanation of important aspects for understanding financial statements, such as accounting policies, the main accounting estimates or internal control elements that are relevant to the audit process [HCCC (Haut Conseil des Commissaires aux Comptes), 2006]. Taking advantage of the existence of extended reports, Bédard *et al.* (2019) examined their relationship with investors' reactions, delays in the publication of the report, abnormal accruals and audit fees, but did not find any significant association.

However, a strand of the literature has reported that the readability of audit reports has improved thanks to ISA 700. Burke *et al.* (2023) analyzed the consequences of adopting KAM in audit reports of the US companies, finding that managers and their auditors anticipate that the insight into critical areas will increase scrutiny of financial statements disclosure. They adapt management disclosures accordingly, indicating enhanced auditor involvement in the reporting process, which may improve the informative quality of financial reporting and benefit investors. Rousseau and Zhems (2023) examined the influence of audit firm guidance on the partner's wording style of KAM. Their results indicate that audit firm guidance is less important than partner style in explaining KAM outcomes, alleviating concerns that audit firm guidance may result in boilerplate KAMs. Seebeck and Kaya (2023) investigated the communicative value of extended audit reports in the UK and found that specific descriptions of KAMs are significantly associated with capital markets reactions, indicating that investors value nonstandardized information.

In sum, previous empirical evidence is mixed, suggesting that the view of auditors can shed light on this area. It may contribute to understanding the effects of the new reporting requirements on litigation risk and operating costs, which may incentivize auditors to disclose KAM using a highly standardized format and formal language, potentially resulting in less informative audit reports.

In this context, we propose our first hypothesis:

H1. Auditors use standardization and formal language in the auditor's report as a mechanism to mitigate increased costs that result from its extended content.

The issuance of standardized audit reports emerges as an important determinant of a potential mismatch between the information disclosed and users' expectations of more tailored insights into companies. This may explain an insignificant effect on the quality of the audit outcome.

2.3 Mandatory audit firm rotation

Long audit tenure has been a matter of concern to regulators as it can create economic bonds and a relation of trust between auditors and clients that may threaten auditors' independence. To mitigate this risk, European and Spanish regulators have established mandatory audit firm rotation for PIEs' clients.

Limiting the tenure of the audit engagements may have significant effects on audit firms and the audit outcome. First, it may create market opportunities for second-tier audit firms in the upper segment of companies, such as PIEs, by replacing the Big 4 as the sole statutory auditors. The audit industry is highly concentrated due to the existence of entry barriers (Ballas and Fafaliou, 2008; Abidin *et al.*, 2010; Ruiz Barbadillo *et al.*, 2016). These barriers create an oligopolistic market in the segment of PIEs, dominated by the Big 4. As in many countries, in the Spanish audit market, Big 4 audit firms provide services to practically all large financial institutions and listed companies. At a second level, there are six large international audit firms: BDO, RSM, Grant Thornton, PKF Attest, Mazars and Auren. These ten companies concentrate approximately 70% of the turnover in the audit market, (60% for the Big 4), following a trend of increasing concentration over time (Garcia-Blandon *et al.*, 2017).

However, there is evidence that the high concentration in the upper segment of the Spanish audit market is consistent with significant competition and rivalry among Big 4 firms (Ruiz Barbadillo *et al.*, 2016), resulting in a good quality of the audit task. On the other hand, in the audit market, concentration is seen as a natural process due to the complexity of the task and the demand for higher quality. Thus, a greater concentration increases the economies of scale and indirectly the quality (Velte and Stiglbauer, 2012).

The evidence regarding the relationship between mandatory audit firm rotation and market concentration is quite conclusive. Theoretically, mandatory audit firm rotation can further increase concentration (Bleibtreu and Stefani, 2018), and empirical studies often support this hypothesis, as large companies tend to appoint another Big 4 audit firm when their auditor is mandated to rotate (Ewelt-Knauer *et al.*, 2012), resulting in a switch of client portfolio of Big 4 audit firms. The results obtained by Kwon *et al.* (2014) in South Korea, Narayanaswamy and Raghunandan (2019) in India, Clacher *et al.* (2019) in the UK, Indyk (2019) in Poland and Wesson (2021) in South Africa indicate the existence of such an association between mandatory audit firm rotation and increased audit market concentration. The combination of mandatory rotation with limits for NAS leads audit firms to abandon the audit assignment in favor of other more profitable tasks (NAS). Thus,

competition is reduced in the audit market, potentially impairing the quality of the audit task.

Therefore, it seems unlikely that non-Big 4 firms will access the PIE's audit market as a result of a regulation mandating audit firm rotation. Only in France, because of a mandatory joint audit regime, non-Big 4 companies have a significant market share (Malis and Brozovic, 2015). In this regard, the new audit regulation offers the option to extend the duration of the audit engagement through joint audit contracts as a means to enhance the participation of non-Big 4 audit firms in the PIE's segment. This would help to increase audit competition by reducing the dominance of Big 4 audit companies (Piot and Janin, 2007).

However, previous research shows that competition gains hinge on the specific policy design. For instance, gains in market share for small and medium-sized audit firms have been reported only when an equal share of workload between the two joint auditors is not required (Guo *et al.*, 2017). Moreover, other studies find that joint audit is not an efficient solution for enhancing competition because it involves higher coordination costs for audit firms and increased fees for clients without obtaining perceived improvements in audit quality (André *et al.*, 2016). Indeed, joint audits can even impair audit quality when the joint auditors are a big and a small firm, due to a free-riding problem that may decrease working accuracy (Deng *et al.*, 2014).

Therefore, in a voluntary environment like the Spanish market, big audit firms may lack sufficient incentive to pursue joint audits. Acknowledging that Big 4 audit firms may switch their client portfolio as a result of the mandatory rotation rule, we expect that the increased market concentration stemming from the rotation regime is not compensated by the use of joint audit contracts that could allow the entrance of non-Big 4 audit firms into the PIE's market:

H2. The incentives provided in the new audit regulation to foster joint audit contracts (i.e. the extension of the maximum duration of the audit engagement) do not compensate for the increased costs and audit fees, and, therefore, big audit firms may decide not to pursue them.

Second, limiting auditor tenure may generate incremental costs to audit firms and audit clients. Previous research has found that higher switching costs due are accompanied by costs incurred to compete for tenders and to hire, retrain and upskill staff to audit new clients in new industries (Harber and Maroun, 2020) or join other departments within audit firms when there is a notable decrease of audit contracts. The Public Company Accounting Oversight Board (PCAOB) estimates cost increases of 20% of audit costs due to audit firm rotation (Ewelt-Knauer *et al.*, 2012). It seems that these costs are not likely to be recouped through higher audit fees, as rotations are often used to negotiate lower prices (Ettredge *et al.*, 2014), resulting in profit pressures (Corbella *et al.*, 2015). It is also documented that audit clients may experience negative effects in the form of adjustment and learning costs when experienced auditors are replaced (Harber and Maroun, 2020; Jia and Gao, 2023). Auditors also incur learning costs when they reacquire prior clients after the cooling-off period (Bleibtreu and Stefani, 2018).

Furthermore, some studies claim that these costs are not outweighed by improvements in audit quality. Most of them investigate the Italian context, where mandatory rotation of audit firms has been in force for more than 20 years and do not find a clear effect on audit quality. For example, Cameran *et al.* (2015) found that rotation does not improve audit quality throughout the entire duration of the audit engagement, but only toward the end, as the turnover deadline approaches. Additionally, some studies adopt a pseudo-experimental

approach, such as those carried out by Nagy (2005) or by Blouin *et al.* (2007). They used the disappearance of Arthur Andersen as a scenario of mandatory audit firm rotation for its former clients and did not find any effect on audit quality. Other studies apply a qualitative methodology to examine the effect of auditor rotation on managers' perception of audit quality (Daugherty and Tervo, 2008). They fail to find significant differences between the level of perceived satisfaction with the professionalism of the service provided by the current auditor and its predecessor but find higher costs (perception of lower value added).

Thus, we anticipate that the new mandatory audit firm rotation rule may result in incremental costs for auditors and audit firms:

H3. Mandatory audit firm rotation results in increased costs for audit firms to compete for tenders, retrain and upskill staff, which are not outweighed by an enhancement in audit quality, at least in the short term.

2.4 Tightening of the prohibition of nonaudit services

The prohibition of joint provision of audit services and most NAS [2] to audit clients presents potential effects on the quality of the audit outcome and the distribution of the PIE's segment of the audit and NAS markets.

Auditors providing NAS are considered problematic because this type of relationship changes the auditor's role from that of an independent outside reviewer to that of an inside advisor. This creates an economic bond between auditors and clients, which may compromise auditors' independence (Francis, 2006). However, the provision of NAS by statutory auditors may also have a positive influence on the audit outcome through knowledge spillover effects that can improve auditors' performance when assessing audit risks (Joe and Vandervelde, 2007), especially when audits are conducted by industry specialist auditors (Lim and Tan, 2008). The provision of NAS can also enhance audit quality (Walker and Hay, 2013; Eilifsen and Knivsfla, 2016), increase auditor cooperation with management (Kowaleski *et al.*, 2018) and generate cost savings for audit firms (Simunic, 1984) due to the flow of knowledge between NAS and auditing, which is then passed on to auditors' clients (Krishnan and Yu, 2011).

Regulators and investors perceive an impairment of auditor independence in the presence of NAS (Quick and Warming-Rasmussen, 2015), but most of the previous empirical research based on archival data does not find sound evidence that the joint provision of audit and NAS negatively affects auditor independence (for instance, Monterrey and Sánchez-Segura, 2007; Carmona and Momparler, 2011). In fact, some studies reported that certain types of NAS may be beneficial for enhancing the quality of the audit outcome. For instance, in the EU, Svanström (2013) found a positive association between current audit-related fees and audit quality in Sweden, measured by abnormal accruals. For the Spanish case, Castillo-Merino *et al.* (2020) analyzed current and future fees, and divided NAS into tax, audit-related and other services. They found that only future fees of other services are related to an impairment of audit quality. Their results also show that in contrast to regulators and investors' perceptions, the joint provision of tax- and audit-related services seems to contribute to improving the quality of the audit service, which is consistent with the existence of knowledge transfer across audit and NAS units at the same audit firm.

Building on previous literature, we hypothesize that auditors may perceive the banning of the joint provision of audit and NAS as a constraint to accessing companies' insights generated while conducting NAS, which can eventually result in a suboptimal level of audit quality:

H4. The prohibition of the joint provision of audit services and most NAS deters the emergence of knowledge spillover effects, affecting audit effort and the quality of the audit service.

Another potential effect of the new rule is on the change of patterns of competition for NAS contracts. The regulatory prohibition of the provision of NAS to audit clients can result in high-quality audit firms (i.e. Big 4 companies) offering more opportunities for NAS competitors, as they may choose to retain high-rent (and high-risk) audit clients and not compete for NAS contracts.

In this regard, Friedman and Mahieux (2021) developed a theoretical model to examine how regulatory bans on the joint provision of audit and NAS can influence the interplay between the audit and NAS markets. Among other results, the authors propose that such restrictions can create a niche for NAS firms because high-quality auditors may decide to invest in audit quality of high-quality (high-risk) clients if there is a positive correlation between NAS and audit demand. This changes auditors' incentives to invest in audit and NAS and to deliver high-quality audits. Thus, NAS restrictions on audit firms can lead to higher investments in audit quality, but the aggregate audit quality can be reduced if low-quality (low-risk) clients of high-quality auditors switch to low-quality auditors.

Regarding the NAS market, the prohibition of the joint provision of audit and NAS may result in decreased concentration in the segment of large clients, enabling new participants (second-tier audit firms and consulting companies) to enter the market.

We aim to verify whether the above theoretical assumption holds in practice according to the auditors' view. Accordingly, we state our next hypothesis as follows:

H5. The prohibition of the provision of most NAS to audit clients is triggering more competition in the NAS market, allowing non-Big 4 audit firms to enter the large client segment.

2.5 Increase in internal quality control and supervision

The quality control mechanisms established in the 2006 European Directive [EC (European Commission) 2006] have been reinforced by the 2014 Directive and Regulation [EP (European Parliament), 2014a, 2014b; EP (European Parliament), 2014a, 2014b], with the adoption of the International Control Standard Number 1 issued by the IFAC, the provision of internal quality assessment of every audit engagement and the enhancement of public supervision and inspection as the main measures.

There is a broad consensus that public oversight of the audit process by independent supervisory bodies is necessary to ensure auditors' independence and contribute to leveraging the quality of the entire audit system. Empirical evidence shows that audit quality improves as a result of the inspection process (Lesage *et al.*, 2016; Westermann *et al.*, 2019; Blann *et al.*, 2022). Sanctions, reputational risks, client loss and litigation risks associated with inspections that identify audit deficiencies (Christensen *et al.*, 2022) can explain increased auditors' conservatism (Sundgren and Svänstrom, 2022), effort and diligence (Li *et al.*, 2020) when conducting their audit tasks. This leads to the deterrence of low-quality audits when there is an increase in oversight enforcement (Lamoreaux *et al.*, 2023). The new audit regulation fosters an increase in inspection efforts by public oversight bodies and higher enforcement, which may be consistent with enhanced audit quality (García-Hernández *et al.*, 2022; Cheynel *et al.*, 2023).

However, in its current form, tight supervisory activity may also lead to potential negative consequences on the quality of the audit system. First, auditors may perceive

inspection processes as an assessment of their professional ability as auditors (Westermann *et al.*, 2019) and a threat to their reputation. Accordingly, they may spend an important part of their time focusing on internal controls and documentation that allows them to demonstrate completion of the audit work, to the detriment of more skilled audit tasks, such as deepening their expertise in accounting standards and the use of critical thinking (Rixom and Plumlee, 2023). Empirical evidence suggests that current audit practices are motivated by passing inspections and characterized by excessive documentation and reduced critical thinking as a consequence of a "box-ticking" approach to the audit job (Westermann *et al.*, 2019), which may impair audit quality (Peecher *et al.*, 2013). In this regard, Stuber and Hogan (2021) found that PCAOB inspections lead to less accurate and conservative-biased estimates of allowances for loan losses in the banking industry. Furthermore, the use of public oversight to ensure compliance with audit standards is consistent with the "slippery slope" theory of audit regulation, which contends that the degree of compliance with a particular regulation is a function of agents' perception of the regulator's power, as well as the trust they have in it. In this field, Johnson *et al.* (2019), interviewed 20 experienced auditors and concluded that the degree of compliance with the US audit regulations is due to fear of repercussions of not obtaining a "clean" inspection and not to conformity and confidence in the regulatory body's vision on how to improve audit quality.

Therefore, it seems that auditors are aware of the power of public oversight bodies and concerned about the consequences of failing to pass an inspection, but they do not perceive the role of inspectors and the procedures as appropriate. Inspections are seen as a "trial" to auditors based on documented evidence (Westermann *et al.*, 2019), but auditors may prefer a collaborative process to work with inspectors while seeking to improve the quality of audit methods and outcomes (Johnson *et al.*, 2019). In addition, the differences in risk perception between inspectors and auditors may result in an inefficient allocation of time and resources by audit firms, as inspectors are more prone to focus on regulatory risk than on client risk and, therefore, may require auditors to generate excessive documentation in areas of low audit risk (Westermann *et al.*, 2019).

Second, since inspection selection by public oversight bodies is based on client risk [Christensen *et al.*, 2022; ICAC (Instituto de Contabilidad y Auditoría de Cuentas), 2022] and audit firms face time and resource constraints because they might not be able to pass on clients the effort required to meet internal control and documentation requirements (Westermann *et al.*, 2019). Consequently, audit firms can decide to manage inspection risk by anticipating the result of the selection process and focusing their audit effort on clients with higher risk to the detriment of clients with a lower risk to be inspected. This may result in an impairment of the average quality of the audit system. The evidence provided by Detzen *et al.* (2024) after conducting an experiment with 182 experienced auditors confirms the threat that inspection risk management results in an impairment of auditors' effort allocation. They found that auditors plan more hours for clients with higher inspection risk and assign fewer hours to clients with a lower risk profile, regardless of the misstatement risk.

We aim to verify whether auditors perceive that the enforcement of inspections by the new audit regulation and the current role of inspectors and their inspection procedures act more as a driver or a barrier to enhance audit quality. Therefore, we pose our next hypothesis as follows:

H6. The increase in inspections and their enforcement by supervisory bodies creates a positive incentive for auditors to conduct high-quality audits, but it also drives some unintended consequences, such as the misallocation of time to more skilled

audit tasks when the requirements of documentation and controls are excessive. Additionally, audit quality may be impaired when auditors concentrate their effort on clients with high inspection risk.

The new rule also reinforces the requirement of an assessment of every audit work to be conducted by another nonstatutory auditor included in the audit network, as a part of the internal quality control system (article 8, 2014 Regulation; article 24 bis, 2014 Directive). In the Spanish case, the engagement quality review is mandatory for all audit firms [article 67 (c), 2021 Regulation]. Previous research has documented a positive influence of engagement quality reviews on audit quality, as they allow for the detection and correction of errors in auditors' judgments (Lambert and Agoglia, 2011; Asare *et al.*, 2005), improve audit risk assessments (Ayers and Kaplan, 2003), induce engagement partners to plan higher levels of testing (Bedard *et al.*, 2008), serving as the foundation of the audit opinion (Ater *et al.*, 2019). However, tight control quality requirements for small audit firms may have side effects. Small audit firms are less capable to bear the costs associated with a more demanding regulatory environment, even if they associate with networks or alliances (Bills *et al.*, 2016). The limited number of management-level individuals in their networks may require small audit firms to exert significant effort to meet quality standards, as they have been compelled to shift from a working papers management to a risk management approach, to invest time in implementing new procedures or to engage qualified individuals from outside the firm to perform engagement quality reviews, with increased costs than can be unaffordable. The result is likely to be an increasing industry concentration (Bedard *et al.*, 2008) and a delisting of small firms as registered audit firms (Read *et al.*, 2004), reducing competition in the audit market:

H7. Internal quality control requirements may lead to a concentration in the audit market, with the merger and acquisition of small- and medium-sized audit firms.

3. Methodology

To analyze the effect of the changes introduced by the audit regulation overhaul, we conduct face-to-face interviews with audit firm partners, following a semistructured script (Gendron, 2009; Borgato and Marchini, 2021; Soares Fontes *et al.*, 2021). Before the interviews, we analyzed the 2014 EU Directive and Regulation as well as the Spanish LAC in detail and conducted four preliminary meetings with audit partners with more than 20 years of experience (two Big 4 and two non-Big 4) to identify the most relevant issues to be discussed and design a script to guide the interviews.

After these meetings, we defined a preliminary script that was later validated by these experts in terms of the relevance of the issues addressed. This three-stage process (preliminary meetings, preliminary script and validation by the four partners) adds robustness to the study design. Once the script design was modified, we eventually arrived at a standardized script (see Appendix) that was used in the interviews as a checklist of topics that interviewees should address.

Five initial items were identified: the extended version of the auditor's report, mandatory audit firm rotation, the prohibition of the joint provision of NAS and requirements of internal quality control. In cases where the interviewees did not mention them, we introduced the topics and they were also given the opportunity to add more issues. After the first interviews, an additional topic was identified: the role of the regulator, which was also included in the subsequent interviews.

We conducted a total of 14 face-to-face interviews. The interviewees were provided with the script before the interview so that they had the opportunity to think about the questions that would be raised (Hermanson *et al.*, 2012). The number of interviewees is similar to Nath *et al.* (2020), with 15 interviews and slightly fewer than the Sormunen (2014), Fontaine *et al.* (2017), Segal (2019) and Fontaine *et al.* (2013), with 18, 19, 20 and 20 interviews, respectively, all within the audit field. We considered 14 interviews to be sufficient, as we have designed the script with the input of four additional partners who agreed on the topics to be covered. After five or six interviews, we observed signs of saturation (DiCicco-Bloom and Crabtree, 2006), indicating that discussed issues and their importance remained consistent. Beyond this point, the responses began to repeat, indicating that data collection was complete.

Regarding the items in the script, the interviewees shared their view as audit partners, as well as those of their company and staff, highlighting both positive and negative aspects and assigning weight to them. Additionally, the script addressed the interviewees' opinions about the effect of regulatory changes on the audit outcome and the audit market. The interviews concluded with a request for a brief conclusion on the strengths and weaknesses of the provisions introduced by the new regulation.

Participants in the study have been identified through personal and professional contacts or were selected by the audit firms upon request. This approach constitutes a convenience sample commonly used in other audit studies (Archambeault *et al.*, 2008; Beasley *et al.*, 2009). The interviews were conducted in Spanish, lasted 1 h each, and all paper coauthors were present. To address resistance, interviews were not recorded, preserving participants' confidentiality and anonymity. It is noteworthy that most of the interviewees preferred not to be recorded to facilitate open discussion. The decision not to record the interviews aligns with the methodology used in other auditing studies (Segal, 2019; Christensen and Seabrooke, 2022). Interviewees were free to discuss topics nonlinearly, deviating from the script as necessary to capture opinions with as little interference as possible. While one coauthor led the interview, the other(s) took notes and intervened only to redirect the discussion back to the script when needed. Subsequently, the notes were transcribed following the script since the interviews often deviated from it. The transcript was then reviewed by the coauthors who made revisions or incorporated additional aspects mentioned in the interviews. Following this review, the transcript was sent to the interviewees for their approval. The results of this study are derived from these transcripts.

Table 1 presents the interview period, along with information on participants' affiliation and tenure. Interviews were conducted between November 2019 and January 2020, three years after the entry into force of the new European and Spanish regulations. We consider this time gap between the regulations' implementation and the interviews to be adequate for obtaining meaningful results because new regulatory provisions require auditors to familiarize themselves with the changes, develop procedures and assess outcomes, particularly when significant changes are involved. In this regard, Maroun and Duboisée de Ricquebourg (2023) emphasize the need for a time gap to analyze the effectiveness of new audit regulations, as auditors require time to develop and refine their processes. Consequently, the authors examined how auditors identify and report KAM through interviews conducted in South Africa from April 2020 to March 2021, a jurisdiction where the new auditors' report regulation (ISA 701) has been applied since 2017.

The study interviewed audit partners from both Big 4 and non-Big 4 multinational audit firms. Of the interviewees, 43% were from Big 4 firms and 79% were men. On average, they had 22.3 years of experience, ranging from 15 to 36 years. The mean experience for Big 4 auditors was 21.2 years, and for auditors of other firms, it was 23.1 years, without significant

ID	Date	Firm	Gender	Years as auditor	Years as partner
1	11/13/2019	BDO	Male	28	17
2	11/22/2019	Grant Thornton	Female	20	4
3	11/25/2019	Baker Tilly	Male	18	4
4	12/04/2019	Mazars	Male	16	3
5	12/05/2019	KPMG	Male	23	3
6	12/11/2019	PKF	Male	36	18
7	12/16/2019	PWC	Male	20	5
8	12/16/2019	PWC	Male	20	6
9	12/17/2019	Auren	Male	15	4
10	12/20/2019	EY	Female	29	14
11	12/20/2019	EY	Male	15	3
12	01/16/2020	RSM	Female	35	16
13	01/16/2020	RSM	Male	17	10
14	01/21/2020	Deloitte	Male	20	7

Source: Table by authors

Table 1. Participant demographics

differences. Concerning their experience as partners, the average was 8.2 years, with a minimum of 3 years and a maximum of 17 years. The mean experience for Big 4 partners was 6.3 years, and for non-Big 4 firms, it was 9.5 years, with no significant differences observed. There were no differences in the opinions expressed in the interviews based on the experience as an auditor or as a partner, but differences were found regarding the type of company (Big 4 or non-Big 4).

4. Results and discussion

To organize the interviews and analyze the influence of the regulatory reform on audit firms, audit outcome and the audit market, we began by identifying the factors that drove the regulation change. The elements were corroborated by the partners who were interviewed. During the interviews, we requested the partners to list the most important issues related to the new LAC in order of priority. Table 2 provides a summary of the relevant elements and their prioritization as provided by the interviewees.

Table 2 will be discussed in the corresponding sections below. However, we can observe that the new audit report, rotation and incompatibility with NAS were mentioned by all 14 interviewees. Regarding greater internal control, one blank space indicates that one interviewee did not mention this item as relevant. For the column of further inspection, five interviewees did not give importance to this aspect. This last issue was not included in the initial script and was only introduced after the first interviews. The fact that 36% of the interviewees did not mention this point gives us an idea of its lesser importance and confirms the adequacy of the initial script. Nevertheless, we decided to mention it in the interviews to gather opinions about it.

4.1 New auditor's report

More than 50% of the interviewees mentioned the new auditor's report as the most important change. According to the audit partners, it seems that the objectives of enhanced audit quality and usefulness for decision-making pursued with the revised report [IAASB (International Auditing and Assurance Standards Board), 2015a, 2015b; PCAOB (Public Company Accounting Oversight Board), 2017] have not been fully met, at

Table 2.
Interviewees' order of priority of the most relevant aspects of the Audit Law

New auditor's report	Rotation	Prohibition of NAS	Internal quality controls	Inspections
1	4	3	2	
1	2	3	4	5
1	4	2	3	
1	2	3	4	5
1	2	3	4	
1	3	2	4	5
1	3	2	4	4
1	4	3	2	5
2	1	3	4	
2	1	2	4	
2	1	3	5	4
2	1	3		4
3	2	1	4	5
4	2	3	1	5

Source: Table by authors

least in the period covered by this study (2016–2019), as there is not a clear perception of increased value over costs by shareholders and lenders. Interviewees do not consider the new information about audit risks to be useful for external users to gather new companies' insights, mainly because of the intense use of "technicalities that are many times only understandable for auditors and accountants," as well as the "repetition of companies' risks in the report over fiscal years." Thus, they mainly do not see an increased quality of the audit outcome. Their view on this matter is consistent with the findings of some previous research, which show that the new auditor's report does not convey additional value-relevant information about companies' insights to external users (Riedl and Serafeim, 2011; Carver and Trinkle, 2017; Gutierrez *et al.*, 2018; Lennox *et al.*, 2019; Bédard *et al.*, 2019). Furthermore, auditors cast doubts about the existence of a positive correlation between the extended report and the quality of the audit service.

However, there is a clear consensus among interviewees that the new version of the report confers the audit process with more transparency, allows auditors to "show external users the insights of their work, and place value on the tasks behind a report." Most of them consider that the new auditor's report may be associated with greater prestige and valuation of the auditor's profession, as pointed out by one of the interviewees:

> The audit report has not improved audit quality by itself, but the increased information of the audit process in the report has enhanced auditors' job, and gives them the possibility of explaining themselves.

Interviewees do not perceive clear tangible benefits for external users but many of them note several related costs. They claim that the implementation of the new auditor's report has led to an increase in audit effort, with "more hours of managers and partners," which has resulted in pressure on audit fees and margins. This result is in line with some previous studies, which stated that increased disclosure might lead to higher audit fees (Vanstraelen *et al.*, 2012; Simnett and Huggins, 2014).

In addition, specific training for audit teams has been necessary, along with clarifying the disclosure of audit risks to clients, as "many of them have been initially reluctant to the inclusion of audit risks in the report, because they identified them as a disclosure of business risks."

Interviewees agree that the number of audit hours and effort have increased without a proportional rise in audit fees. They consider that audit effort is mostly driven by the disclosure of KAM because it increases their perceived responsibility. Consequently, it changes the way auditors conduct audit planning and testing, demanding more attention and a careful review to avoid mistakes. As one of the interviewees pointed out:

> In the new report, there is more exposure for the auditor, which increases liabilities. Thus, we need to be more cautious with the content because audit deficiencies are now more evident.

The inclusion of a statement that, in line with ISA 240, asserts that the auditor has planned the audit to obtain reasonable assurance that companies' financial statements are free from material misstatement, caused by error of fraud, may have contributed to reinforcing the perception of increased responsibility and liability.

In line with the conclusions of Gimbar *et al.* (2016) and Backof *et al.* (2022), the perceptions of the auditors interviewed point to a higher litigation risk in the new auditor's report and a consequent need to reduce potential consequences. As stressed by previous research, the standardization of the report, especially concerning KAM, can be a strategy for auditors to mitigate the risks of litigation and, therefore, reduce contingencies derived from a more customized and insightful report (Seebeck and Kaya, 2022).

According to the answers of the interviewees, Big 4 auditors have tried to avoid standard reports allowing engagement partners to "apply their own style but meeting some general basic parameters," which is consistent with the spirit of the IAASB's rule. They usually adapt the report to the particular situation of the audited company after starting with a general and common writing provided by the audit firm. However, Big 4 auditors, who conduct the audits of most PIEs, express their concern about their exposure when disclosing KAM, and the need for a thorough quality control review. Thus, it seems that the need for alleviating the liability risk associated with the disclosure of KAM in the report results in a disclosure of "clients' general audit risks (that) are repeated over time," limiting its usefulness to gathering and monitoring companies' insights. Therefore, we detect an "intrafirm report standardization" in the case of PIE auditors, which adds evidence to the findings of previous studies (Lennox *et al.*, 2019; Kend and Nguyen, 2020). In this regard, some of the interviewees highlighted a progressive reduction in the number of audit risks over time, which is consistent with the trend toward standardization.

The generalization of audit risks in the report is even more evident in the case of non-Big 4 auditors. The interviewees accept that they tend to use the same reporting guide for all companies in the same industry. Thus, there is the risk that the report could remain as just another formalism, since the KAM disclosed could become standardized texts. This is because, according to the interviewees, KAM are similar to companies in the same industry with the main issues written in a standard way. This "interfirm standardization" of the auditor's report narrows the provision of value-relevant information to external users.

We observe a higher level of report standardization for smaller companies, as they typically lack significant complexities, allowing the text to be largely homogenized based on common content in similar companies. As noted by some interviewees, the specific case of the Spanish regulation is contributing to the standardization and diminishing relevance of the new auditor's report. The Spanish audit law (article 5, LAC) mandates the use of the new auditor's report for all companies, unlike in many European countries where it applies to listed companies and PIEs. Although the extended report is designed for larger companies that may benefit from the enhanced information and transparency, the Spanish legislator opted for its universal application. The prevailing opinion among the auditors interviewed is that it should not be uniformly applied to all the firms. Not all companies have the same

requirements, and in most cases, non-PIEs would not necessitate as much detail. In summary, the obligation to prepare an extended report is viewed as a requirement that introduces significant incremental costs and contributes to both "intrafirm" and "interfirm" standardization of the auditor's report.

The findings presented in this section align with prior research (Christensen *et al.*, 2014; Riedl and Serafeim, 2011; Carver and Trinkle, 2017; Lennox *et al.*, 2019; Kend and Nguyen, 2020) confirming our first hypothesis (*H1*). The standardization of the report, the use of homogenized language and the repetition of content can be interpreted as auditors' response to mitigate exposure to liabilities and associated costs stemming from longer and more sensitive content, potentially undermining the added value of the new report.

4.2 Mandatory audit firm rotation

Opinion in this area is not unanimous. There is a general perception that excessively long tenure might hinder the ability to maintain a critical and objective perspective on the client's transactions, potentially compromising auditors' scepticism. However, interviewees emphasize that it is routinization of audit tasks rather than familiarity with the client that poses a risk to audit quality. They agree that this risk could be mitigated through periodic rotation of the engagement partner and their team, similar to partner rotation practices in the US market (Laurion *et al.*, 2017). This conclusion aligns with findings from numerous studies that analyzing the relationship between auditor tenure and audit quality (e.g. Gul *et al.*, 2009; Paterson *et al.*, 2019).

There is a clear consensus among interviewees that mandatory audit firm rotation primarily affects Big 4 audit firms in Spain. Non-Big 4 partners criticize the situation, pointing out that the Big 4 firms audit most PIEs (approximately 1,000 companies in Spain, including listed, regulated, large companies and collective investment funds), a phenomenon akin to a "trading card exchange" occurs. When a Big 4 firm completes its engagement with a PIE, the audit contract typically shifts to another Big 4 firm. Entering this market poses significant challenges for new players due to important entry barriers, such as the requirement for a large international operational structure and a prestigious reputation often associated only to Big 4 firms exhibit. This observation aligns with the findings of previous studies (Kwon *et al.*, 2014; Clacher *et al.*, 2019; Narayanaswamy and Raghunandan, 2019; Indyk, 2019; Wesson, 2021).

Hence, changes in PIE auditors have not led to a rise in the participation of non-Big 4 audit firms in the PIE market. The audit landscape for PIEs remains heavily influenced by Big 4 audit firms, leaving minimal opportunities for new entrants. Despite the explicit aim of the European regulation to diminish the market share of the Big 4 and foster competition, it has not succeeded in promoting more competition in the audit market for large companies.

As one interviewee noted regarding the decreased competition in the segment of large clients:

> [. . .] when it comes to rotation, if a Big 4 loses a client, only three audit firms remain eligible for that contract. If one of them has any conflicts of interest, and another provides NAS to the company, then there is only one left.

Moreover, interviewees view joint audit contracts as a mechanism to reverse this situation. However, there is no unanimity that joint audits are a feasible channel for medium-sized audit firms to access large companies' audit contracts as they are currently defined in the regulation. On the one hand, non-Big 4 partners believe that it could be an opportunity for their firms to enter the PIE's market, improve their know-how and enlarge their operations' scale amid reducing audit costs and enhancing quality. However, they acknowledge that

seeing them in practice is difficult unless they are strengthened through regulatory provisions, as seen in the French setting (Francis *et al.*, 2009) because Big 4 firms are not prompting joint audit engagements. There is a general criticism of the limited development of joint audit contracts in the Spanish audit market.

On the other hand, most of the Big 4 partners acknowledge that shareholders and directors perceive "a higher cost from joint audits that is not outweighed by clear gains in financial reporting quality." Moreover, interviewees consider that coordinating joint audits is difficult in the Spanish audit market. In line with the findings of André *et al.* (2016) and Deng *et al.* (2014), they believe that there are no clear synergies between large and smaller audit firms; sharing know-how, organizational culture and procedures is very challenging; different quality standards exist, leading to two distinct audits rather than collaborative work. However, auditors believe that the main constraint for the development of joint audits is that "audit responsibility and risks cannot be limited in practice," which emerges as an area of improvement if regulators aim to promote joint audit contracts as a mechanism to enhance competence in the PIE's segment.

Auditors' view endorses our second hypothesis (*H2*), indicating that large audit firms do not have sufficient incentives to pursue joint contracts because the increase in coordination costs and audit risks outweigh the potential benefits.

In contrast to non-Big 4 interviewees, mandatory audit firm rotation is an important regulatory change for Big 4 partners because it significantly alters their audit clients' portfolio, compelling audit firms to develop "strategies than combine audit and NAS tenders." The fact that one Big 4 firm, Deloitte, had a significant market share in the Spanish PIE's segment has led to significant switching costs.

For the majority of auditors interviewed, switching costs pose a risk of impairing audit quality with a new auditor. On the one hand, there is the possibility that the audited clients take advantage of the new auditor's lack of knowledge in their favor by applying more aggressive estimates and valuations. On the other hand, the probability of misstatement increases due to the lack of previous experience in reviewing the company's financial statements.

The background of the participants supports the notion that client companies do not usually exploit the inexperience of new auditors for their own benefit. However, the need for new auditors to compensate for their lack of knowledge with increased audit effort to minimize the probability of misstatements is confirmed, leading to the emergence of a source of margin erosion. In this regard, previous studies found evidence of increased audit effort and low-balling of initial year audit fees following an audit firm change, suggesting a negative impact on the quality of the audit outcome in the short term (Ettredge *et al.*, 2014).

In addition, and according to the view of interviewees, the loss of clients represents another source of significant cost for audit firms. They are required to compete for new tenders and invest in retraining, upskilling and reorganizing their staff to equip them with new skills applicable to other services when audit engagements are lost. These findings align with those of Harber and Maroun (2020), who provided evidence that switching costs associated with a mandatory audit firm rotation regime are accompanied by additional costs to hire, retrain and upskill staff to audit new clients in new industries. This impact is not limited to auditors alone but extends to specialists in other areas who are incorporated into audit tasks, as audits increasingly require support from professionals in various fields, such as tax specialists, lawyers and computer scientists.

Auditors identify a negative spillover in the increasing number of young auditors leaving the job, as they are compelled to perform tasks outside their designated roles to a certain extent. As some interviews claim, "the job is not as prestigious as before; the audit

profession is currently perceived as a step or a bridge toward other more valued professions."

These results lend some support to our third hypothesis, which posits that mandatory audit firm rotation triggers significant related costs that are not outweighed by enhanced audit outcomes in the short term.

4.3 Tightening the prohibition of nonaudit services

Auditors highlight the reinforcement of the prohibition of the joint provision of audit and NAS as a third important provision in the new regulation. The objective of the increased restrictions is to enhance auditor independence [EP (European Parliament), 2014a, 2014b].

However, it seems that the new rule is also yielding some unintended effects in this area. Generally, interviewees perceive the changes relative to previous regulations [EC (European Commission), 2006] as less significant since, in most instances, these new requirements were already being adhered to internally. Auditors confirm that, in many cases, their firms do not provide NAS to large companies (PIEs) during the audit engagement. Nonetheless, the strengthened prohibition of the joint provision of NAS and audit services by incumbent auditors has prompted increased focus and effort on ensuring independence, as it is deemed "the most important source of sanctions in Spain." Before every audit engagement, "a thorough review of threats to auditor independence is conducted, accompanied by a meticulous protocol and documentation process." According to the interviewees, the enhanced assurance of independence is resulting in increased costs for audit firms, albeit with a moderate impact on firms associated with multinational networks. The new requirements have necessitated greater investment in information technology and human resources departments to ensure adequate control measures. Additionally, in most cases, audit firms have opted to establish a specific department dedicated to these tasks.

Interviewees have also emphasized the comprehensiveness of the new provisions, as well as the discretion applied by regulators when deciding the type of service to be banned. Some participants acknowledge that some NAS, especially tax and some audit-related services, offer valuable insights to conduct high-quality audits and do not necessarily pose a threat to auditors' independence if sufficient precautions are taken (for instance, limiting their scope to services identified as valuable inputs for the audit task, as well as monitoring the amount billed to audit clients). They perceive that certain types of NAS may contribute to enhancing, rather than impairing, audit quality by improving the inputs available to perform audit tests and reducing audit hours. These results align with prior studies, particularly with the findings of the quantitative analysis conducted by Castillo-Merino *et al.* (2020) for Spanish firms. This is consistent with the assertion of our fourth hypothesis (*H4*), which posits that the prohibition of certain types of NAS may hinder knowledge transfer across audit and NAS departments, increasing audit effort and potentially impairing the quality of the audit service.

In addition, Big 4 partners claim that the loss of a client's audit account may lead to a potential increase in NAS to offset the loss. Interviewees consider the shift across the firm's departments as a natural change in many cases. They state that audit firms use NAS to reallocate resources when large clients are lost:

> "There is a concern about the loss of auditor talent, and with NAS it can be retained. The outcome is more valued and higher priced than audit services, and it is not as demanding in terms of regulations to comply with."

Non-Big 4 partners emphasize that the banning of a joint provision of audit and NAS is a clear opportunity to enter the PIE's segment, as "Big 4 audit firms have very strict

independence controls and need to hand over NAS contracts to second tier audit firms." This finding aligns with Friedman and Mahieux's assumptions (2021), which suggest that NAS restrictions can create a niche for non-Big 4 firms because high-quality auditors may decide to invest in audit quality of high-quality (high-risk) clients, leaving room for other participants to compete for their NAS contracts.

Interviewees observe an increase in competition in the NAS market as a consequence of the strengthening of the new regulation regarding the prohibition of joint provision of audit and NAS. This results in an opportunity for medium-sized audit firms to compete for the NAS contracts of Big 4 audit clients, finding a path to enter the PIE market. This positive externality in market dynamics supports our fifth hypothesis (*H5*).

4.4 Increased inspections and internal quality controls

In general, the increase in inspection efforts by the supervisory body is the least emphasized aspect in terms of importance, and in some cases, it has not arisen spontaneously or has not been considered significant. Some interviewees note that inspections have increased and become more rigorous, while others have not undergone inspections. In any case, inspections are primarily focusing on large audits. Auditors anticipate more inspection work, and there is a heightened obligation for all tasks to be thoroughly documented. Additionally, in the case of the report, the disclosure of KAM allows inspectors to focus on the most sensitive aspects.

Auditors believe that inspections and the risk of sanctions are critical mechanisms to ensure the correct adoption of regulatory provisions and, eventually, to enhance audit quality. This conclusion aligns with previous studies that find a positive correlation between the inspection process and audit quality (Li *et al.*, 2020; Sundgren and Svänstrom, 2022; Blann *et al.*, 2022; Lamoreaux *et al.*, 2023). As one interviewee points out:

> The increase of inspections is the real driver of audit quality enhancement.

However, according to the responses of the interviewees, we identify two important side effects of the inspection process in the Spanish case. First, the inspection approach consists of reviewing documented evidence to identify and sanction potential failures in applying audit standards. Thus, in line with some prior research (Westermann *et al.*, 2019; Johnson *et al.*, 2019), auditors claim that inspectors are more focused on assessing regulatory risks than on discussing the quality of audit methods and outcomes. Interviewees are aware of this approach and the consequent sanction risk. They also acknowledge that the selection of inspections by the Spanish Public Supervisory Board (ICAC) is based on client risk due to the limited number of officials available. This leads audit firms to allocate a significant amount of time and resources to generate documentation and prepare for potential inspections of the audits of large clients, increasing audit effort that cannot be translated into higher audit fees and may limit the resources available for other audit services.

Second, interviewees, particularly Big 4 partners, claim that Spanish inspectors do not have an adequate audit background. This is a direct consequence of the requirement of independence of supervisory bodies from the audit profession in the audit regulation and makes inspections "sluggish bureaucratic" processes that mainly aim to comply with formal requirements. Therefore, inspections, in its current form, do not seem to directly contribute to enhancing the quality of the audit service.

Auditors' view is consistent with our prediction in sixth hypothesis (*H6*). The inspection process must be improved to overturn current auditors' perception that inspections are a burden, requiring increased effort to generate excessive documentation without any direct enhancement of the audit outcome.

Regarding internal quality controls, interviewees noted that the new regulation leads to assuming more tasks and responsibilities, resulting in the establishment of more filters and controls to ensure the quality of the audit outcome. The work embedded in each professional position (partner, manager [...]) was standardized before the new regulation took effect, placing greater importance on planning. Now, audit partners must have a real involvement by legal imperative, and, as a result, the job process is managed differently because the departments of professional practice and independence are much more involved.

However, Big 4 auditors consider that the increase in processes and controls was not a novelty. As one interviewee points out:

> The gap for the big ones was smaller; they already had their homework done.

Big audit firms had already established internal quality systems because they belong to multinational networks, which impose more restrictive controls. However, non-Big 4 auditors criticize that the increase in internal processes and controls is "making the audit work more complex and requires investing more resources, thereby expanding the cost structure." Interviewees complain that more formal procedures and controls have brought along a burden of excessive administrative tasks, as well as the inability to bill these additional costs to their clients.

Interviewees consider that effective quality controls are associated with higher standards of audit quality and that control systems must be implemented for key processes: risks, quality standards, conflicts of interest [...] This aligns with existing evidence (Ayers and Kaplan, 2003; Asare *et al.*, 2005; Bedard *et al.*, 2008; Lambert and Agoglia, 2011; Ater *et al.*, 2019). However, auditors also acknowledge that the strengthening of quality controls demands "the involvement of experienced staff, which is costly for audit firms." In larger firms, some partners must assume these tasks. However, in smaller companies, all partners are required to share them, thus increasing the effort and the time devoted to each audit. As one interviewee points out:

> I spend more time filling out paperwork than doing the auditor's job.

The common opinion is that the requirements of internal quality controls, such as the assessment of every audit work to be conducted by another nonstatutory auditor included in the audit network, may be an excessive burden for small audit firms and come with a cost that they cannot bear. Auditors consider that the current regulatory environment demands a large operational structure; thus, a minimum size is needed for audit firms to survive. Some interviewees claimed that the new legal provisions will likely lead to mergers and acquisitions of the smallest audit firms, which will result in more concentration in the audit market. This view is consistent with the prediction stated in our last hypothesis (*H7*), as auditors perceive that the increase in requirements is likely to decrease competition in the Spanish audit market.

5. Conclusions

This paper analyzes the effects of the 2014 European regulatory reform on auditors, the audit outcome and the audit market through the views and opinions of the auditors, with a focus on the Spanish market. It aims to contribute to shedding light on the effectiveness of the audit regulation reform which has not garnered a large consensus between regulators, practitioners and academics. This lack of consensus raises concerns about the effectiveness of the new provisions in ultimately improving the quality of the audit service and the potential emergence of side effects on auditors' activity and the audit market.

The main conclusion is that auditors perceive the new provisions in the audit regulation as generating unwanted effects on audit firms and the audit market that may outweigh the potential benefits of improved audit quality. The concerns about the influence of European and Spanish regulations on audit quality are aligned with the findings of the quantitative study conducted by Cabal-García *et al.* (2019) for the Spanish market. However, beyond this evidence, our paper identifies several side effects of the new provisions, which may emerge as issues to be considered in the future agenda of national and international regulators to improve audit standards.

One of the most important changes is the extended auditor's report. Auditors perceive higher exposure and increased liabilities from the expanded content of the report and try to reduce potential harmful consequences through the use of guides at the firm level and conducting thorough reviews of partners' disclosures. As a result, we identify a general intrafirm report standardization, especially concerning KAM, and, in some cases, an interfirm or industry standardization. Thus, the standardization of the auditor's report seems to arise as a strategy to mitigate litigation risks and avoid mistakes. In addition, the universal mandatory regime in the Spanish regulation emerges as another source of standardization and use of boilerplate language, as auditors seek to reduce the costs associated with the extended report in small companies.

The standardization of the auditor's report could result in an audit outcome that fails to meet users' expectations for more detailed and customized information about companies' insights, thereby undermining the intended benefits of the new report format. Therefore, regulators should foster projects aiming at limiting standardization in KAM disclosures and better clarifying the role and responsibilities of auditors for misstatements, particularly those caused by fraud. Additionally, they should consider limiting the extended report to PIEs or scaling up size requirements for auditing financial statements.

Moreover, auditors consider that the new mandatory audit firm rotation regime is not enhancing competition in the highly concentrated segment of the largest companies in Spain, neither through the substitution of Big 4 by non-Big 4 audit firms nor via the use of joint audit contracts that could allow big firms to extend the duration of their engagements. The evidence for the Spanish audit market is consistent with prior findings in other countries, where mandatory audit firm rotation has led to reduced competition, as large companies tend to appoint another Big 4 when their statutory auditor is mandated to rotate.

Since Big 4 are mainly replaced by other Big 4 audit firms, there is no room for new players and without more competition, large audit firms have no clear incentives to engage in joint audit contracts. Auditors consider that the main constraint for the development of joint engagements is that auditor responsibility and litigation risks are not clearly defined in practice. Thus, regulators should be aware of the weak performance of joint audits as they are currently defined and consider the need to assess their enforcement through mandatory provisions amid further clarifying the role and responsibilities of the joint auditors.

In addition, mandatory rotation of audit firms is triggering increased competition for tenders and costs of retraining and upskilling staff, as well as generating the risk of losing qualified and well-trained employees, which is not compensated by a tangible enhancement of the quality of the audit service.

Concerning the strengthening of the prohibition of a joint provision of audit and most NAS, there is a certain consensus among auditors about the discretion applied by regulators when they decided to ban them since they acknowledge that some of them, such as tax and some audit-related services, may facilitate knowledge transfer across audit and NAS departments. Therefore, regulators should include in their agenda a careful cost-benefit

analysis of banning different types of NAS when they conduct their postimplementation review of the audit standards.

A positive effect identified by interviewees is that the ban on NAS is enhancing more competition in the NAS market. It is increasing the chance for second-tier audit firms to compete for the NAS contracts of Big 4 audit clients, providing them a way to enter the PIEs market.

The new regulation introduces an increase in inspection efforts by supervisory bodies as a mechanism to ensure the correct adoption of regulatory provisions. However, auditors consider that the inspection process in Spain presents some deficiencies that impair its potential benefits of enhancing audit quality. On the one hand, inspections are selected based on client risk and are focused on the assessment of regulatory risks rather than on audit quality. On the other hand, inspectors do not have a professional background. This results in formal processes focused on the review of documentation previously prepared by auditors, making them ineffective in enhancing the quality of the audit service and requiring auditors to devote considerable time to prepare evidence at the expense of the audit activity. Therefore, regulators should consider including audit experts among the staff of supervisory bodies and fostering more collaborative inspection processes focused on audit risks and aiming at improving the quality of audit methods and outcomes.

Finally, there are new requirements for auditors regarding quality controls for many key processes. Auditors consider that quality controls are associated with higher standards of audit quality. However, they also acknowledge that these requirements have two important unintended effects: the bureaucratization of the audit job and increased audit effort, which is resulting in the loss of young talent; and the emergence of increased costs that cannot be billed to audit clients. The incremental costs of quality controls are seen as an excessive burden for small audit firms, which puts their survival at stake. A direct consequence of this is an increasing trend of mergers and acquisitions between small and medium-sized audit firms, leading to more concentration in the Spanish market. In light of this situation, regulators should include in their agendas the discussion of comprehensive policies that help small audit firms gain size (for instance, through joint audit contracts) while adopting measures that may promote competition in the audit market. Additionally, they should also consider scaling up audit thresholds, to better align regulatory provisions with audit firms' size.

The present study should be of interest to academics as well as professionals and regulators. The qualitative methodology used enables a causal analysis of the main elements introduced by European and Spanish regulations and their effects on audit firms, audit outcomes and the audit market. The results obtained may be useful to the IAASB and to European and Spanish regulators in assessing the effectiveness of the new audit provisions.

Our research is not free of limitations, which, in turn, present avenues for future research. The relatively small number of interviews and their focus on the largest auditing firms in the Spanish market may lead to a certain bias in opinions, preventing direct extrapolation to other market segments. Therefore, more qualitative studies are needed to examine whether the effects identified by partners of the largest audit firms hold true when considering the perspectives of professionals in other positions (associates, managers) and/or partners affiliated with medium and small-sized audit firms. Additionally, our focus on Spain and the opinions of audit partners working in Spanish firms makes it challenging to generalize the results to other EU countries despite sharing the same audit regulatory framework. Thus, it would be beneficial to analyze similarities and differences in auditors' perceptions across European countries. Finally, further quantitative research would also be valuable to

empirically verify the effects of the new regulations, such as the standardization of the auditor's report, increased audit market concentration, competition in the NAS market or the impact of enforced public oversight on audit quality.

Notes

1. The British FRC – Financial Reporting Council – approved the requirement to apply the extended version of the auditor's report established in ISA 700, which was revised by the IAASB in June 2013. This requirement applied for fiscal years ended on or after September 30, 2013 (Financial Reporting Council, 2013).
2. This prohibition affects the auditors of the entire network of the audit firm (PE, 2014b, article 5, paragraph 1).

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Appendix

(1) In your opinion, what have been the four main changes introduced by the reform, from most to least important? Examples:
- Rotation.
- Auditor's report.
- Internal controls.
- Market externalities.
- [. . .].

(2) Do you think there are any more relevant changes?

(3) Could you comment on the effects of the above changes at the firm/organizational level? Examples: Changes in processes/procedures, increased personnel, greater effort, more clients [. . .]
- Positive effects.
- Negative effects.

(4) Could you comment on the person-level effects of the above changes? Examples: more training, new tasks [. . .]
- Positive effects.
- Negative effects.

(5) Could you comment on the effects of the above changes on the quality of the audit service?
- Positive effects.
- Negative effects.

(6) Could you comment on the effects of the above changes on the audit market?
- Positive effects.
- Negative effects.

(7) Summary. Overall, do you believe the change has been positive or negative? Provide a synthesis.

Source: Appendix by authors

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