# The Effect of the Financial Crisis on the Accounting Profession in the United States and Europe

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Abstract

While the accounting profession received a great deal of the blame for the 2007-2008 financial crisis, it was only one of a myriad of factors that contributed to the subprime mortgage debacle and resulting economic downturn. The crisis not only affected the market in the United States, but also had a significant impact on the worldwide economy, and especially that of the European Union. In the aftermath of the crisis, existing audit policies and standards were brought into question, and while slight changes were implemented in the U.S. as the result of the Dodd-Frank Act, more substantial reform took place in the EU with the implementation of policies such as mandatory audit firm rotation and increased oversight.

# The Effect of the Financial Crisis on the Accounting Profession in the United States and Europe

During 2007 and 2008, the United States underwent a season of economic uncertainty on a scale that had not been seen since the Great Depression. The collapse of the subprime market, housing market, and stock market were devastating events that affected consumers and corporations alike. As the dust eventually settled, many looked for a guilty party on whom they could place the blame for the precarious situation that had occurred in such a sudden and violent manner. Some placed their focus on the accounting profession, blaming its valuation techniques and lack of accountability and oversight for the weakened state of the economy. Ultimately, the accounting profession deserves a relatively small portion of the blame for the 2007-2008 financial crisis, but the reform that followed allowed the industry to placate the concerns of its critics.

## The Subprime Crisis in the United States

Before analyzing the fallout that followed the events of the late 2000s, it is first necessary to understand the circumstances that created the financial crisis. One of the most significant contributors was the concept of the subprime loan, which refers to “less than highly creditworthy assets that yield higher interest rates than do prime assets with similar non-credit risks” (Ryan, 2008, p. 1609). The typical subprime loan was targeted towards individuals with a suboptimal financial standing: limited documentation of income and assets, a FICO credit score under 660, and a debt-to-income ratio of around 50% (Ryan, 2008). These individuals did not qualify for a prime loan, and were forced to instead settle for a subprime loan at a higher interest rate in exchange for the inherently more significant risk assumed by the lending institution. Some subprime loans were riskier than others, and were often assigned grades between A- and D based on the borrower's recent credit history (Ryan, 2008). However, the difference was stark; prime loans incurred five times lower credit losses than even the highest-rated subprime loans (those rated A-), a figure that becomes even more drastic during periods of declining housing market value (Ryan, 2008).

In the mid-1990s, American subprime loans greatly increased in volume, as financial institutions became more willing to undertake these risky ventures for several key reasons. First, most of these loans were used for the purchase of real estate and automobiles, so banks would not suffer a complete loss in the event of a defaulting customer; the real or personal property that served as collateral for these loans effectively minimized net losses as long as the assets in question maintained the bulk of their value (Chomsisengphet & Pennington-Cross, 2006). Second, reduced demand for fixed prime mortgages created a void of profitable opportunities for banks, and many turned their attention towards the lucrative potential of higher interest rates and a much larger market of users (Ravier & Lewin, 2012). Finally, the combination of extremely liquid markets and increasing competition in the emerging industry meant that many risky customers were granted interest rates that had no hope of remaining at their initial levels (Ryan, 2008).

These subprime loans soon gained traction in several other countries apart from the United States, and by 1998, the debt and hedge fund crisis of the Russian economy served as a precautionary tale to the dangers and risks involved in subprime lending (Eichengreen & Park, 2002). A government-issued "moratorium on external debt payments" caused "debt market participants [to shun] credit-risky investments in favor of high credit-quality investments," (Ryan, 2008, p. 1609) creating an extremely volatile situation in which subprime interest rates increased severely. Many homeowners were not able to pay the massive interest payments, leading to high default rates that resulted in severe losses for mortgage-backed securities and their investors; however, this crisis was largely contained to these investors due to the fact that the Russian housing market was appreciating in value, allowing most financial institutions to escape unscathed (Eichengreen & Park, 2002).

The warning signs demonstrated by the Russian crisis were initially heeded by American investors and lending entities, as subprime mortgages plummeted from 15% of issued mortgages to only 8% between 1998 and 2003 (Ryan, 2008). However, as the event faded out of recent memory, caution was soon discarded, and the previously discussed implications of subprime lending became altogether too appealing despite their risk. Once again, subprime loans became a prominent part of the American economy, making up one out of every five loans issued between 2004 and 2006 (Ryan, 2008). The housing market continued to appreciate, but as customers with increasingly poor credit scores were offered services, default rates increased and cut into the profitability that the banks had enjoyed for a brief period (Ryan, 2008). The competition intensified between 2004 and 2007, and banks faced declining profitability despite their assumption of considerably greater risk. In search of even more potential customers, some institutions offered options such as delayed payments and adjustable-rate mortgages that made loans initially more affordable to a greater number of borrowers. The inadequate state of regulatory controls was also taken advantage of, as mortgagors manipulated customers' credit scores and falsified information on mortgage applications to create more qualified applicants (Ryan, 2008).

Unfortunately, very few stopped to consider the precarious situation that had been churning below the surface. The U.S. market as a whole vastly "underestimated the credit risk inherent in subprime [mortgage-backed securities (MBS)] before the subprime crisis," as most operated under the flawed "assumption of continued robust housing appreciation" (Xua, 2014, p. 72). The subprime crisis' effect on the American economy would have likely blown over as a notable but otherwise insignificant event had the housing market continued to appreciate as it had in Russia one decade earlier; a few investors would have suffered losses, but the banks could have sold the defaulted homes and managed to maintain their liquidity. Unfortunately, the housing market's eventual collapse magnified the losses that banks had already been sustaining for several years, causing massive write-downs and severe illiquidity that crippled many financial institutions and forced a few to file for bankruptcy (Ryan, 2008).

The events of the actual subprime crisis can be broken up into four distinct waves, as demonstrated by Ryan (2008). The first wave occurred in February 2007, when the two largest issuers of subprime mortgages, HSBC and New Century Financial, announced poor outlooks for the coming year (Ryan, 2008). New Century Financial restated its prior year financial statements to correct repurchase losses that had been vastly understated, and HSBC increased its expected loss estimates by 20% due to changing market conditions (Ryan, 2008). These revelations created immediate repercussions across the industry, and banks quickly stopped issuing subprime mortgages; those who were most exposed became aware that their losses would greatly surpass their original estimates, and they began laying off many employees as a result (Ryan, 2008).

By April, New Century went bankrupt, marking the beginning of the second wave. While the first wave did not significantly affect most investors, the credit crunch that occurred in the summer months of 2007 began to demonstrate the reality of what was occurring: the riskiest mortgage backed securities lost nearly half of their value, but surprisingly, their higher-rated counterparts remained largely unaffected (Ryan, 2008). However, this would change during the third wave in fall 2007, as Merrill Lynch, Citigroup, and others announced multibillion-dollar losses, finally affecting senior MBSs and eliminating most of the value of junior MBSs. Finally, the fourth wave stretched into the early months of 2008, in which major players in the bond insurance industry, MBIA and Ambac, recognized billion-dollar losses along with other credit and mortgage institutions (Ryan, 2008).

## The Subprime Crisis in Europe

While there were certainly a number of fatal market tendencies and strategic decisions that created the circumstances leading up to the subprime crisis, it quickly became evident that subprime mortgage-backed securities were profoundly intertwined with many aspects of the national and global economies. As those in the European Union looked on at the first rumblings of financial trouble that were occurring in America, many believed that "the European economy…would be largely immune to the financial turbulence" (European Commission, 2009). They pointed to economic indicators such as growth of exports, strong fundamentals, and encouraging financial positions for both individuals and corporations (European Commission, 2009). However, within a short period of time, it became clear that European banks were dangerously exposed to the U.S. subprime market, and hindsight shows that the two economies had several international factors in common that contributed to the crisis' severity .

During the mid 2000s, both North America and Asia were recovering from fairly significant financial events, and in several countries, such as Japan and the United States, the economic authorities made an effort to reverse the damages that their financial systems had suffered. In Japan, the government was trying to overcome the lingering effects of the 1980s bubble economy, and in America, the Federal Reserve was trying to compensate for the dot-com bubble that had occurred a few years prior. As a result, both nations featured especially accommodative federal monetary policies that reduced interest rates and consequentially enabled the existence of a phenomena referred to as carry trades (European Commission, 2009). In these ethically questionable trades, international companies and investors borrowed money in countries with favorable rates, before investing them in countries that were enjoying stronger currencies (European Commission, 2009). The parties who participated in these trades faced minimal consequences, and the European Union was forced to ease its own monetary policy in an attempt to remain competitive and combat the effects of the imported inflation created by carry trades (European Commission, 2009). This overcompensation by the EU created a situation in which asset prices soared, but inflation levels remained static, creating a new bubble that unfortunately linked the European economy to the financial crisis that was brewing in America.

Despite many experts' predictions that the EU would be remained largely unaffected during this period, the first major indicator of the crisis' international implications was BNP Paribas' halting of investment fund redemptions; this event sent shockwaves across the previously nonchalant European financial sector as it became evident that their banks were significantly exposed to the U.S. subprime market (European Commisison, 2009). BNP Paribas' actions occurred due to rising uncertainty in the valuation of their investments, as it had become very difficult to quantify the actual collectible amount on many MBSs (European Commission, 2009). Banks across the region began to charge extremely high interest rates on interbank loans, as maintaining liquidity became the most obvious means to survival for these institutions. European banks that had assumed they would be immune to the crisis, such as Landesbank Sachsen and Northern Rock, soon experienced the same fate as that of their American counterparts (European Commission, 2009). Fearing the same destiny, institutions that had exposed themselves to similar risks began to unload assets at severely reduced prices in order to maintain sufficient liquidity.

In the immediate aftermath of the crisis, the European and American governments responded very similarly, reducing interest rates and exchanging their cash and municipal bonds for banks' toxic assets in an attempt to resuscitate their damaged economies. However, the damage had already been done, and both regions suffered relatively comparable consequences of considerable impact. While American banks were forced to write down investments that totaled close to $300 billion, it is estimated that European banks faced write-downs of between 500 and 800 billion euros, or roughly 400-600 billion U.S. dollars (European Commission, 2009). While America had enjoyed a relatively low unemployment rate prior to the financial crisis, the European Union's already high rate increased by a comparable amount during the period in question, as shown in Figure 1.

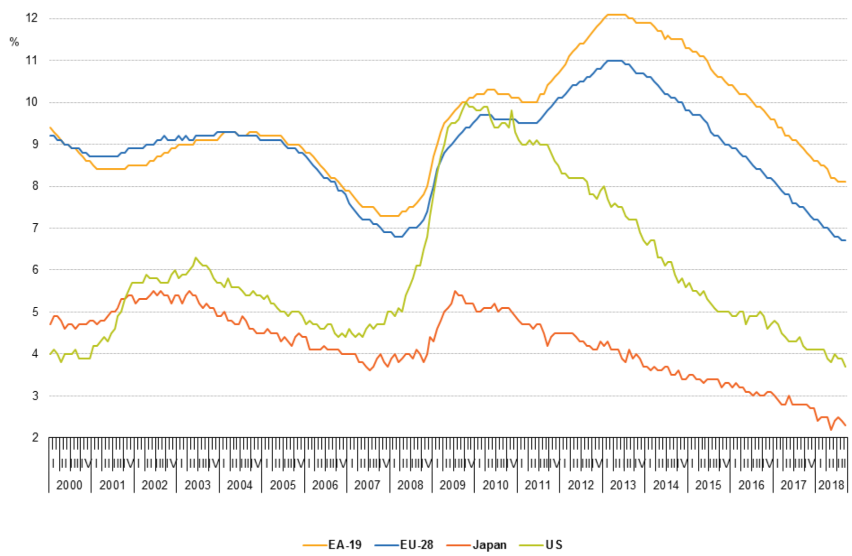


Figure 1: Seasonally adjusted unemployment rates, January 2000 – September 2018 (EuroStat, 2018)

Other smaller and poorer countries across the region suffered as emerging market investments severely declined, and individual consumers began to save more money as opposed to spending on durable and discretionary spending. EU members such as Hungary, Germany, and Ireland experienced monumental GDP reductions, contributing to a Union-wide GDP decrease of 5% in 2009, the worst since the Great Depression of seven decades prior (European Commission, 2009). The countries that suffered the worst were those who relied heavily on exported goods and who had stockpiles of inventory at the time of the crash, victimized by the contracting of world trade and the aforementioned decline in consumer demand. A few of these countries even required financial assistance from organizations such as the World Bank, International Monetary Fund, and the EU itself (European Commission, 2009).

## Resulting Audit Reform in the United States

### Fair-Value Accounting

As interested parties began to examine the causes of the financial crisis in its aftermath, some suggested that the use of fair value accounting (FVA) had exacerbated a merely bad situation by contributing to the paranoia that led to the more widespread crisis that resulted (Masood & Bellalah, 2014). These critics argued that FVA had inaccurately measured investments due to the illiquid market, creating a tailspin of public perception that quickly sunk the market. In order to assess the accuracy of such a claim, it is first necessary to gain an understanding of the concept of fair value accounting. Masood & Bellalah (2014) defined the term as follows:

> Fair value accounting is a financial reporting approach in which companies are required or permitted to measure and report on an ongoing basis certain assets and liabilities (generally financial instruments) at estimates of the prices they would receive if they were to sell the assets or would pay if they were to be relieved of liabilities (p. 238).

The Financial Accounting Standards Board (FASB) has addressed this topic in several issued standards, the most significant being FAS 157, and there are many situations in which FVA could either be allowed or required to be applied in practice. In relation to the subprime crisis, these standards generally dictate that subprime positions should be present at fair value on the financial statements, and that any resulting unrealized gains or losses should be recorded on the income statement or statement of other comprehensive income (Masood & Bellalah, 2014). This option, when implemented, creates a more holistic view of the solvency and current asset valuation of a given firm based on recent market events. As the subprime crisis featured a considerably lengthy period of illiquidity, the involved companies were forced to record their financial instruments on all financial reports at the price that they could hope to procure if they had been sold on the balance sheet date (Masood & Bellalah, 2014).

In relation to FVA, FASB created a "hierarchy of inputs into fair value measurements, from most reliable to least reliable" (Masood & Bellalah, 2014, p. 244). The first level includes "unadjusted quoted market prices in active markets for identical items" (Masood & Bellalah, 2014, p. 244); while this level is typically the most reliable, it could not be applied to subprime positions due to the unique nature of these securities. The second level of the hierarchy allows estimates to be made directly or indirectly based on available market data (Masood & Bellalah, 2014). This method takes a combination of similar item pricing and analysis tools like yield curves and exchange rates in order to approximate the value of a company's assets; this is usually the most commonly used in practice for MBSs, but it created problems due to the ambiguous and unstable nature of the quality of many subprime positions.

Lastly, the third level utilizes entity-supplied estimates based on historical data, market assumptions, and future forecasts (Masood & Bellalah, 2014). Obviously, the subjective nature of these estimates supplied by the company itself means that this valuation method is usually very unreliable. It is used infrequently, except in times of market instability; this is due to the declining number of orderly market transactions from which to infer a more objective estimate. As the credit crunch of the subprime crisis intensified, financial institutions were forced to employ this third method more often, resulting in extensive documentation such as reconciliations and descriptions related to their subprime positions (Masood & Bellalah, 2014). This method also requires ample disclosures if given estimates are expected to fluctuate significantly within the next year, as well as if notable value-changing events occurred between the audit period end date and issuing of financial statements (Masood & Bellalah, 2014). Further complicating matters, there was little consistency in asset valuation at the start of the crisis, as some institutions adopted estimates based on their own models, while others attempted to continue basing their assumptions off of market value. Additionally, companies that filed under International Accounting Standards Board (IASB) standards had much more sporadic guidance related to FVA for financial instruments as opposed to those who filed under FASB's more systematic standards (Masood & Bellalah, 2014).

Some critics would argue that by its very nature, FVA seemingly creates an environment that encourages a cyclical sequence of economic events (Ryan, 2008). As the market encounters a period of downturn or poor growth, the resulting fair value adjustments to financial assets further reduce the profitability of the already compromised institutions. This causes the market to suffer more, leading to more markdowns, eventually reaching a point where investors are spooked and opt to sell their positions in stocks and mutual funds (Ryan, 2008). Banks face reduced liquidity and are forced to sell their assets at bargain prices, essentially locking in the losses that they had recognized, and further weakening their financial positions and limiting their ability to eventually recover (Ryan, 2008).

While these concerns are accurate to an extent, it is also perhaps accurate to consider that "the subprime crisis was caused by firms, investors, and households making bad operating, investing, and financing decisions, managing risks poorly, and in some instances committing fraud, *not by accounting*" (Ryan, 2008, p. 1607, emphasis added). Stated alternatively, the declining economy and mounting losses that were experienced during the subprime crisis were the result of poor decision-making by a variety of financial players, and not solely the fault of the accountants who followed guidance and recognized these losses at fair value. Some proponents of FVA even suggest that more stringent and diligent observance of the practice would have reduced the credit crunch's impact and expedited the "price adjustment process by providing market participants with the most accurate and complete information about subprime positions" (Masood & Bellalah, 2014, p. 238). They argue that if financial institutions had come to terms with the true nature and quality of their investments earlier, they would not have continued down the path that led to more poor decision-making and the resulting immense losses.

In fact, the increasing importance that has been placed on the financial industry in past decades is essentially what has created the need for FVA and other similar practices. Financial assets have proven to be an increasingly integral sector of the economy in recent history, albeit more volatile, and FVA was developed as a means of reflecting the constant fluctuation of valuation for these securities (Nolke, 2009). Many banks and investing institutions rely very heavily on the purchasing, holding, and sale of these assets, and as a result needed a way to more accurately communicate the results of their trading in a time-sensitive manner (Nolke, 2009). If they had been trading productive assets, which are not as volatile, they could have recorded assets at historical cost and presented a fairly accurate picture of their operations, but the recognition of unrealized holding gains and losses under FVA created a way to convey net income in a manner that better reflected the nature of their industry. Furthermore, the case can be made that the alternative method of historical cost accounting features just as many problems, if not more, in its treatment of assets such as financial instruments; this is largely due to that fact that it does not provide the real-time feedback that FVA offers (Nolke, 2009).

## The Dodd-Frank Act's Impact on Accounting

When considering changes in the accounting industry over the past two decades, the Sarbanes-Oxley Act of 2002 (SOX) is the most significant piece of legislation that comes to mind. However, that Act was mostly the result of numerous accounting scandals, such as Enron, Worldcom, and Tyco, that took place in the late 1990s and early 2000s. For the purposes of this paper, the Sarbanes-Oxley Act will not be covered, but its wide-ranging impact is important to note before considering the audit reform, or lack thereof, that resulted directly from the subprime crisis.

Passed in 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act relates mostly to the financial services industry and its requirements for transparency, oversight, and accountability (Holder, Karim, & Jingrong, 2012). However, that does not mean that its requirements can be disregarded by the accounting industry, and in fact, the Act includes several provisions that are of particular interest to the auditing profession. The first significant update relates to Internal Control over Financial Reporting (ICFR), a report that was initially required to be auditor-attested for all public entities under Section 404(b) of the Sarbanes-Oxley Act (Holder et al., 2012). This requirement was particularly strenuous for smaller companies that wished to go public, and the Dodd-Frank Act created a permanent exception for all companies with less than $75 million in public float (stock held by public investors) (Holder et al., 2012). This update quelled concerns that the reporting requirements for small businesses had become excessive and restrictive, and lessened the demand for auditor internal control reporting to a more manageable level.

The Dodd-Frank also created the Consumer Financial Protection Bureau (CFPB), while increasing the responsibility of several government entities, including the Public Company Accounting Oversight Board (PCAOB), Securities and Exchange Commission (SEC), and Government Accountability Office (GAO) (Holder et al., 2012). These all greatly impact the function and responsibilities of auditors in a variety of contexts. The vast majority of accounting work will be unaffected by the creation of the CFPB (all services that are considered “customary and usual”), as it exists mostly to regulate the increasingly complex and risky financial sector (Holder et al., 2012). However, certain niche ancillary services that can be provided by accountants, including tax refund and anticipation loans, fall under greater scrutiny with regard to this new federal bureau (Holder et al., 2012).

While SOX created provisions for the PCAOB to share its findings and information with various governmental authorities, the Dodd-Frank Act goes one step further, allowing the Board to share data with foreign authorities as needed. Additionally, after SOX stated that broker and dealer auditors were required to register with the PCAOB, the Dodd-Frank Act laid out the specific guidelines for “standard-setting, inspection, and disciplinary authority regarding broker-dealer audits" (Holder et al., 2012, p. 13). This change increased governmental oversight of auditors in several new capacities, increasing the scope of the PCAOB's influence to many non-publicly traded entities that had previously been exempt. At least initially, the Board considered creating specialized audit standards for this increased area of responsibility, and currently provides various supplemental aid, guidance, and potential discipline on their website for auditors, brokers, and dealers for which compliance is required (PCAOB, n.d.).

In contrast to the CFPB and PCAOB, Dodd-Frank does not require the Securities and Exchange Commission to regulate specific aspects of the accounting industry. Instead, the SEC was tasked with overseeing and reporting a variety of relevant information to Congress; this includes reports on industry-related proposals and developments, new proposals to the financial industry and their impact on stability, and the financial literacy of investors (Holder et al., 2012). Similarly, the Government Accountability Office was tasked with a report regarding financial planners who failed to comply with existing guidelines, as well as one that compared frequency of financials restatement for Section 404(b) filers and those who were exempt (Holder et al., 2012). Generally speaking, these reports were created in order to give Congress better insight into the needs of and create more awareness of the needs and tendencies of the financial community, and thereby prescribe changes to the work of auditors and their oversight entities in order to provide a more thorough and relevant service to those that benefit from their work.

As provisions of SOX, Dodd-Frank, and other legislation like the Affordable Care Act began to go into effect, the need for accountants skyrocketed in the early 2010s. Even more accountants were needed as the economy rebounded and companies began to explore mergers, acquisitions, and new initiatives once again. By 2012, the top 25 largest accounting firms were enjoying annual staff growth of nearly 8%, and pay for accountants increased by nearly 4% year over year nationwide (Laermer, 2012). Despite the increasing regulations and requirements of the accounting profession during the decade under study, the industry as a whole enjoyed the direct benefit of increasing demand and compensation for what were now federally mandated requirements for many companies.

While the financial crisis in America was largely the result of questionable decision-making by financial institutions and consumers, it still provided the opportunity for further refinement of accounting regulation. A cursory glance might create the impression that fair value accounting was a driving factor in the chaos and paranoia of the financial crisis, but in reality, it merely served to more accurately report the questionable financial and lending practices of the time period. Valuation accuracy is extremely important for external stakeholders, so the underlying logic behind the implementation of FAS 157 was necessary to combat these various environmental factors. Additionally, the Dodd-Frank Act contributed to a corporate environment that featured even more accountability and clearer requirements for financial sector auditors. Together with its promotion of increased communication between domestic and international oversight agencies, the Act served a vital role in creating a dynamic regulatory environment and standardizing effective industry service.

## Resulting Audit Reform in Europe

While much of the early 2000s consisted of wide-sweeping reform to European audit policy, the vast majority of these enacted plans and directives were meant as a means of bringing the region's audit practice up to speed with its international counterparts. However, the financial crisis' global impact sparked an increased urgency to extend the audit reform's reach even further. It took a few years, but by 2011, EU commissioner Michel Barnier proclaimed that "there are weaknesses in the way the audit sector works today, and the [global financial] crisis highlighted them" (Kandemir, 2013, p. 213). With this statement, the European Commission released the Green Paper on Audit Policy, seeking to start a discussion of ways to improve existing measures and to implement new, effective ways of restoring faith in auditor independence. Indeed, while past reform had focused on reducing complication in the lives of auditors, companies, and users of financial information, it had become clear that auditor independence was absolutely essential to the audit environment (European Commission, 2009). The Green Paper discussed issues such as increasingly massive accounting firms, and questioned the expediency of the increasing trend of firm consolidation (European Commission, 2009). The Commission argued that these firms had gotten so big, that the failure of even one of them would threaten the operation of the financial markets; firms might begin to consider themselves too large to be held accountable for their actions, and neglect audit quality and effectiveness due to a lack of urgency (European Commission, 2009).

The Green Paper also looked to the United States and its implementation of the PCAOB; the European Union lacked a similar overseeing body, and suggested that one was needed in order to provide stakeholders with educated auditors who thought critically and offered a higher level of assurance. The Commission's report also sought to reduce the negative perception of "qualified" audit reports, as they had become shunned by both auditors and clients despite their practical purpose of highlighting isolated discrepancies (European Commission, 2009). This perception was likely due to stakeholder understanding, and it was suggested that more education efforts were necessary in order to restore the value of the qualified report, along with auditor efforts to increase understandability and improve communication regarding external reporting.

While most EU audit policy at the time was comparable to pre-SOX policy in the United States, the European Commission benefitted from being able to consider the events of the financial crisis in its process of reform. As a result, it considered, and in some cases, implemented several measures that would actually surpass those that had been adopted in the U.S. The Commission outlines its thought processes in the Green Paper, pointing out several key deficiencies of the current state of auditing. One such discussion point relates to "the fact that auditors' responsibility is to the shareholders of the audited company and other stakeholders although they are paid by the audit company," creating what is almost an inherent conflict of interest (European Commission, 2010, p. 11). Other considerations were given to increased transparency in the financial statements of audit firms themselves, more accountability among audit firms and their governance models, and various other means of supervision for European accounting firms (European Commission, 2010).

Ultimately, after considering all of the discussion points of the Green Paper on Audit Policy and the resulting commentary from accounting firms and stakeholders, the European Union issued an updated statutory audit reform in 2014. Starting in mid-2016, European public-interest entities (all credit institutions, publicly-listed companies, and insurance companies) were required to observe mandatory audit firm rotation (MAFR), which will be discussed in greater detail below (European Commission, 2014). Additionally, restrictions on non-audit services were intensified, and firms were prohibited from offering bookkeeping, corporate finance, tax, and internal control consulting services to their audit clients (European Commission, 2014). Finally, increased responsibilities and stipulations were introduced relating to the audit committee; all members must possess relevant experience in the sector, and there must be at least one committee member who is considered an accounting or audit expert (European Commission, 2014). As a whole, these changes sought to increase auditor independence while promoting stronger internal controls and awareness.

**Mandatory Audit Firm Rotation**

One of the most substantial changes that was implemented in the 2014 European audit reform was the introduction of mandatory audit firm rotation for public-interest entities. Previously, accounting firms were required to observe mandatory audit partner rotation (MAPR), in which lead audit partners were prohibited from auditing a particular client for longer than five consecutive years; the partners were then required to refrain from performing audit services for that specific client for a time-out period of five years (Dorsey and Whitney LLP, 2003). In addition, partners apart from the lead audit partner were required to take two years off in between seven-year periods of consecutive audit work with the same company (Dorsey and Whitney LLP, 2003).

The benefits of MAPR in theory are well-documented. Forcing a new partner to work with a client every five years will promote fresh perspectives and creative thinking, likely resulting in more thorough fieldwork and review (European Audit Reform, 2017).

Mistakes made under the previous audit partner's lead will be more likely to be uncovered by a replacement with potentially different experiences and interpretations. However, in addition to error and fraud detection, MAPR exists in an attempt to prevent misplaced trust and complacency between partners and their clients (European Audit Reform, 2017). As the two parties build rapport over years of interactions, the threat exists that the auditor will think less critically and maintain a more nonchalant attitude towards the acquaintances that he has worked favorably with in the past. For example, if an auditor has examined a particular company's findings for fifteen years, never encountering an issue, it can become routine to glance at a few reports for an account and conclude that the numbers are appropriate, leaving the entire audit susceptible to fraud that could have occurred. Alternatively, lengthy relationships can potentially create opportunities for collusion to commit fraud, where the auditor turns a blind eye to questionable practices in exchange for the company's continued business (European Commission, 2014). MAPR seeks to reduce these risks, creating an environment where auditors can maintain independence in both fact and appearance while promoting professional skepticism and objectivity.

However, MAPR does not come without its inherent costs. The biggest concern among auditors is the "lost institutional knowledge related to client-specific matters" (Daugherty, Dickins, Hatfield, & Higgs, 2013, p. 31), as the partner of each five-year rotation is responsible for spending ample preparation time learning about the business' operations, historical decisions, and the unique circumstances that come with any client. These hours of prep time for the partner, along with staff assistance in the transition, create a situation that is much costlier as a whole. Furthermore, while MAPR is meant to reduce fraud, it also might create situations where it is easier for companies to make misleading changes at the beginning of each five-year period; these changes might be detected by an auditor who was more familiar with their status quo and historical state of affairs. As a result, there is no consensus on whether the costs of MAPR outweigh its benefits.

In addition to these considerations related to audit quality under MAPR, the strain that such changes place on the auditors themselves must also be discussed. In figure 2, Daugherty details the "potential trade-offs between quality of life and audit quality," emphasizing that more stringent audit reform will have unintended consequences in its quest for the ideal accounting environment (2013, p. 31). While there are clear potential pitfalls such as extended workloads for key members of the audit, it is possible that concepts such as MAPR lead to poorer quality audits. As partners and staff are forced to rotate between companies and industries, a learning curve exists before they have obtained an ample understanding of the particular client and its business. Some studies suggest that two and a half years are needed on average in order to sufficiently comprehend a new industry, and as a result, lead partners in certain circumstances may

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Figure 2: Model of Direct and Indirect Effects of Mandatory Rotation on Audit Quality (Daugherty et al., 2013)

not be truly effective until the engagements' third and fourth years (Daugherty et al., 2013).

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While SOX provided for the implementation of MAPR in the United States starting in 2003, it also included provisions for a joint study by the GAO and SEC to explore the implementation and impact of MAFR. Ultimately, the study concluded that "mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record" (Cameran, Negri, & Pettinicchio, 2015, p. 5). While the topic has been revisited a few times in the years since, it has largely been deemed unnecessary and impractical for all involved, at least for the time being (Cameran et al., 2015). However, the regulatory authorities in Europe considered the potential benefits, and decided to go one step further by mandating MAFR as part of the aforementioned European statutory audit reform. This decision was made in an attempt to better combat the potential for excessive familiarity and lax auditing services.

Specifically, under MAFR, the same accounting firm is not able to audit a company for greater than ten consecutive years, except in certain situations involving joint audits and multiple audit parties (European Audit Reform, 2017). The underlying benefits and costs of this practice is very similar to that of MAPR, but the former tends to exaggerate the factors that were discussed earlier, offering greater auditor independence at an even greater cost of lost institutional knowledge and auditor man-hours (European Commission, 2014). Additional issues arise when the company being audited is located in a rural area, or operates in an obscure or uncommon industry. It might already be difficult to find multiple firms that offer services in that distinct region or specialty, and under MAFR, this company may be forced to switch to an audit firm that is not as highly specialized or professionally touted, sacrificing both cost and quality in an incredibly disruptive process (KPMG, 2017).

While the European Union had already started the process of audit reform in the early 2000s, albeit in a painstakingly slow manner, the financial crisis provided added motivation for quicker passing of legislation that would provide greater assurance for the region’s many stakeholders. The system’s flaws were made abundantly clear, and while it still took a few more years of public discussion to discern the appropriate path forward, the statutory audit reform update that was passed in 2014 achieved a notable step forward in the prevention of conflicts of interest and promotion of more effective controls and risk awareness. The implementation of mandatory audit firm rotation was met with a fair amount of opposition by those who worried it would affect audit quality, institutional knowledge, and auditor quality of life. However, these concerns were overshadowed by the potential for fewer conflicts of interest and reduced opportunity for errors and fraudulent activity; additionally, this measure provided a resounding figurehead of the

EU’s commitment to taking the necessary measures for a more stable financial environment.

## Conclusion

The events of the financial crisis were frequently blamed, at least partially, on the accounting profession and its assurance practices. However, after closer review, it appears that there were many other parties that deserve a much greater share of the responsibility for the events that transpired. There were, however, several relevant suggestions for the improvement of the accounting industry that served to increase the scope and improve the effectiveness of many existing policies and regulations. In the United States, the necessity of fair value was confirmed, and the Dodd-Frank Act further refined guidance that had begun under SOX. Meanwhile, in the European Union, the introduction of reform such as increased government oversight and mandatory audit firm rotation created a more effective and independent audit environment that would be capable of supporting the unique needs of the financial sector. Ultimately, while it was not always swift or unanimous, the accounting reform that resulted from the financial crisis has served to create an environment that will be better prepared in the event of a similar future crisis.

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