

AUDIT FIRM ROTATION AND AUDIT QUALITY: CASE OF THE LISTED ROMANIAN FIRMS

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Abstract: *The research paper aims to reflect the impact of audit firm rotation on the quality of audit using a questionnaire-based survey. To move towards this objective, we have performed a survey based on a questionnaire, distributed by email to the Board of Directors, Supervisory Board, Top management and Executive management of Romanian listed firms. The results suggest that although the relationship with the auditor is a good one, most of the respondents consider that (voluntary) audit firm rotation increases the audit quality. Regarding the letter issued to the audit committee, as part of the new rules introduced by the EU audit legislation which are intended to strengthen corporate governance and to enhance transparency of audits to investors and audit committees, the most of the respondents consider that additional information disclosed in the audit report tend to be more relevant to the Management of the Company. However, no relationship could be identified between the mandatory rotation and the audit opinion. Finally, we noted that the financial reporting statements suffer changes rather due to IFRS request or operational and financial activity of the auditee than to the auditor's rotation.*

Key words: *audit rotation; audit quality; audit opinion; audit committee; EU Directive*

JEL Classification: M420

Introduction

In view of the international accounting scandals, as well as the financial crisis of 2008, authorities around the world have begun to explore how the quality of audit reporting could be improved. The auditors were accused of not being competent and/or independent enough to prevent such scandals, i.e. to foresee a financial crisis.

One of the most discussed topics was the auditor's rotation.

The auditor's rotation involves setting a limit of years within which an auditor can audit the financial statements of a particular company. The auditor's rotation can mean both the rotation of the audit firm after a certain number of years and the rotation of the audit partner, in which case only the partner in charge with signing the audit opinion must be changed, the audit firm being able to remain the same. The auditor's rotation rule has not been and is not consistently applied across the globe.

Two of the world's two most important regulators, namely the European Commission (EC) in Europe and the US PCAOB, have addressed this issue in very different ways. While the EU, after implementing the mandatory rotation rule at partner level in 2006, they decided in 2014 to extend the mandatory rotation to audit firms. In Romania, the rule of mandatory rotation at partner level was established in 2013 by the adoption of the Code of Ethics at national level, and later, in 2017, the rotation of audit firms was introduced by the adoption of Law No. 162 which transposed Directive No 56 and Regulation No 537 issued by the EU in 2014.

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On the other hand, the US implemented the mandatory rotation rule of the audit partner in 1978, but they decided, after long discussions, which also involved academics and public consultations, not to introduce the rule at the level of the audit firm.

The reform of the European Union (EU) on auditing has a significant impact on contracts between the entities concerned, statutory auditors within the EU, redefining the local and global market for professional services.

Directive 56/2014 and EU Regulation 537/2014 contain a number of requirements which establish the new direction of the statutory audit of a public interest entity (PPE) in the EU and amending the Statutory Audit Directive in force since 2006.

In Romania, Law 162/2017 transposes the EU audit reform, namely the provisions of EU Directive 56/2014 and the options of EU Regulation 537/2014.

The key elements of the Regulation apply to EU Public Interest Entities (PIE) and they are related to:

- Mandatory Rotation of the Audit Firm;
- Non-Audit Services;
- Extended role of the Audit Committee

In Romania, the definition of PIE is more comprehensive than the definition provided by the new EU legislation, including in this category state, national companies and the majority of entities regulated by the National Bank and the Financial Supervisory Authority.

The changes that this legislation brings to the EU are significant, the measures adopted have a clear and unequivocal impact on the quality of the audit, the independence of the auditor and the strengthening of corporate governance. We believe that the adoption of International Audit Standards in all EU Member States, the requirements for extended auditor reporting and the strengthening of the role of Audit Committees in the EU will contribute positively to quality assurance in audits.

Literature Review

The Romanian literature related to the quality of audit reporting is aligned with the international trend and focuses mainly on the independence of the auditor, given the direct link between independence and the quality of the information disclosed (Robu et al., 2016). The audit quality has been intensely debated over time and is regulated by a number of standards adopted even before the implementation of the new reform regarding the obligation of auditors' rotation. In this respect, in December 2009, the International Audit Standard ISA 200 "Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing" was adopted. According to the International Audit and Insurance Standards Council (IAASB), ISA 200 should be seen as a starting point in developing an understanding of the basic objectives and requirements that should be respected in all audits of financial institutions.

According to this standard, there are two general objectives of the auditor:

First, the auditor's responsibility is "to obtain reasonable assurance that the financial statements as a whole do not show significant inaccuracies, either because of fraud or error, thus allowing the auditor to express his opinion as to whether the financial statements are prepared, in all respects significant, in accordance with an applicable financial reporting framework." Secondly, ISA 200 clearly mentions that the auditor is responsible for communicating the findings discovered during the audit mission. In addition, ISA 200 contains an objective relating to situations where reasonable assurance cannot be obtained, in which case the auditor, depending on the circumstances, may be in a position to express a qualified audit opinion or unable to express an audit opinion. In other words, ISA 200 refers to the code of ethical conduct that all professionals must comply with, as well as to the quality control measures underlying an audit.

Also, in 2009, the IAASB issued the International Quality Control Standard (ISQC) which aims to analyze the organization and functioning of an audit firm and to assess the application,

within the company, of international standards and professional rules issued by these bodies. The main purpose of this standard was to set the basic principles and essential procedures to support audit firms in the development of an internal quality control system. Among the significant issues that were addressed during the design of this standard were:

- Aligning the Quality Control Standard (ISQC 1) with the IFAC Code of Ethics for Professional Accountants;
- Whether to provide definitions of quality/quality control and reasonable assurance;
- Consideration of the audit partner's rotation for commitments other than audits of listed entities and rotation of team members for audits of listed entities;
- Consider the rotation of the audit partner who carries out the quality control of the audit file and the request for a break period before he can act again as an audit partner for the same client;
- Clarification of quality management responsibilities within the audit firm;
- Resolve differences of opinion;
- To what extent a firm could rely on an independent external inspection system to determine the scope of its own internal monitoring system;
- Whether the proposed quality control standards have sufficiently addressed the needs of small and medium-sized audit firms.

Another important step taken to strengthen the independence of auditors, namely to improve quality reporting in audits, was the approval of the Ethical Code at national level by decision of CAFR No. 53 of 12 December 2013 on the adoption of the 2013 Manual Code of Ethics for Accounting Professionals, drawn up by the Council for International Standards of Ethics for Accountants (IESBA) of the International Federation of Accountants. The decision of the CAFR Council was published in Official Gazette No. 24 of 13 January 2014. The latest version of the International Code of Ethics for Accounting Professionals is the 2018 edition, which came into force in June 2019. According to it, all professionals are required to join the International Code of Ethics for Accounting Professionals issued by IESB and to implement a quality control system for carrying out audit, review, other assurance missions and related services in accordance with applicable standards (ISQC 1 and ISA 220). The responsibility for implementing the internal control system in Romania belongs to ASPAAS for statutory audits, respectively CAFR for financial audits.

The literature mentions that the evaluation of quality control in audit can be carried out both at the level of the professional body and at the level of the audit firm.

The European Commission draws attention to the importance of auditors' independence and to ensuring a high quality of statutory audits within the Union. The European audit reform deals particularly with this issue, one of the measures adopted being the establishment of the Audit Committees. Audit firms carrying out statutory audits at public interest entities shall prepare an additional report for the audit committee of the audited entity at the latest on the date of the audit report. This report contains information related to the nature and frequency of communication with the audit committee, the scope and timing of the audit and explains the statements related to the events identified during the audit that may affect the entity's ability to continue its work. The auditor shall also communicate to the audit committee the materiality, describe the methodology used and report any significant deficiencies identified in the audited entity's financial statements, as well as whether or not the deficiency has been resolved by management.

The extended role of the audit committee and related activities in the with external audit:

- Monitoring the level of audit fees;
- Evacity of compliance for allowed non audit services;
- Non audit services approval allowed;
- Issuing guidelines and policies;
- (Re)-appointment of statutory auditors;

- Extending the tenure of the auditor;
- Monitoring the auditor's independence.

The mandatory rotation of audit firms was considered a reform to enhance the independence of the auditor and the quality of the audit. However, before presenting the results of our research, it is necessary to clarify the relationship between the independence of the auditor and the quality of the audit, as well as how they were measured by the researchers. According to DeAngelo (1981), the quality of audit services is defined as the likelihood that an auditor will discover a violation of accounting rules and report that breach. The likelihood of an auditor discovering the accounting error depends on his technological capabilities, the audit procedures used, etc. The probability of reporting an error discovered is a measure of an auditor's independence from a particular entity. In other words, it is obvious that there is a direct link between the quality of the audit and the independence of the auditor. IFAC differentiates between independence in mind and independence in appearance. Independence in mind is defined as “the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment” (IFAC, 2001) and, as a state of mind, can't be observed by the public. The independence in appearance is about avoiding facts and circumstances that could be perceived by the others as compromising the auditor's “integrity, objectivity or professional skepticism” (IFAC, 2001). The independence in appearance is at least as equal as the independence in mind, as the main objective of the auditor, i.e. to increase public trust in the audited financial statements, will not be achieved if the own credibility is lost (Quick and Warming Rasmussen, 2005). Appearance matters, when it comes to auditing, having regulators concerned with the identification of threats to the auditor's independence. As the independence of the auditor is binding for the credibility of the audited financial statements, and the independence in fact can actually not be observed, the perceived lack of independence is in its turn a lack of independence (Olazabal and Almer, 2001).

The relationship between the audit quality and the auditor rotation is a topic of great interest in literature, being debated by many researchers in the field, due to the importance of this concept nowadays. However, the empirical evidence varies a lot and the results are mixed, mostly due to the research settings used by the scholars in the past. Based on literature review we have identified different proxies used to measure the audit quality. For example, considering audit failure as a measure for audit quality, Geiger and Raghunandan (2002) argues that U.S. companies going into bankruptcy are less likely to have received a positive audit opinion from audit firms with shorter tenure. The opinion of the two researchers mentioned above is also supported by Carcello and Nagy (2004), who state that fraudulent financial reporting is more likely when the tenure of the audit firms is short. On the other hand, considering earnings quality as an audit quality measure, Chung and Kallapur (2003) and Myers et al. (2003) found out that discretionary accruals are negatively related to audit firm tenure in U.S. firms. The same conclusion has been reached by Johnson et al. (2002) and Gul et al. (2007) who found out evidence of higher discretionary accruals recorded by companies in the first years of the audit firm's tenure. Similarly, Davis et al. (2009) found out that earnings quality increases in the first years of audit firm tenure and later deteriorates. Using audit opinion as a measure for audit quality, Vanstraelen (2000) has compared different audit firm engagement lengths in Belgium and the results obtained suggest that long-term audit firm engagements significantly increase the probability of issuance of an unqualified audit report.

The main proxies used in the academic literature may be grouped into two categories:

- Measures based on the type of opinion issued by the auditor
- Measures based on the earnings quality of the auditee

Measures based on the type of opinion issued by the auditor

One of the ways in which the quality of the audit could be measured is related to the final outcome of the audit activity, i.e. the audit opinion. Many studies have used the audit opinion to

identify cases where users of financial-accounting information could be misled by an incorrect opinion issued by the audit firm. Jere R. Francis refers to 2 types of audit opinions:

- False positive opinion, when a qualified opinion is issued for an entity that does not go bankrupt;
- False negative opinion, in which case an unqualified opinion is issued for a bankrupt entity.

Measuring the quality of the audit by the quality of the result disclosed²

Perhaps one of the most used tools for measuring the audit quality is the quality of the disclosure of the result. This hypothesis is based on the assumption that a high audit quality should lead to a higher level of quality related to the financial statements published by the audited entity. The most studies measure the quality of the presentation of the result by analysing the provision recorded or not, as a result of the own interest of persons in charge, with the only purpose of manipulating the result. This model aims to determine the volume of provisions arising from accounting manipulations.

Other ways of measuring the quality of the presentation of the result involve market perception. One such example is the ERC (earning response coefficient) which measures how changes in share prices are reflected in the change in an entity's earnings.

The audit opinion and the quality of the presentation of the result remain the main indicators for measuring the quality of the reporting in the audit, but we must mention that the literature of specificity indicates other factors that can be considered in measuring the quality of the audit. For example, DeAngelo (1981) suggests that size could be an indicator of audit quality because the larger the size, the more independent an audit firm is in its relationship with the audited entity.

The Romanian literature follows the international trend and focuses mainly on the auditor's independence, given the direct link between the independence and the quality of the disclosed information (Robu et al., 2016). There are concerns regarding the financial dependence on a single client (Turlea et al., 2011), as well as the relationship between the workload and the audit fees during the financial crisis (Bunget et al., 2014).

Research Methodology

To obtain the information referred to in the practical part of our research, we used a survey based on a questionnaire, the research instrument being an original questionnaire designed considering the information gleaned from our critical literature analysis. The database containing the searched companies was obtained from the website of the Bucharest Stock Exchange. We have identified 88 companies listed on BVB's regulated market. This research focused only on respondents who are in charge with Governance according with Law 31/1990, namely the Board of Directors, Supervisory Board, Top management and Executive management of Romanian listed firms. Therefore, the questionnaire was distributed exclusively to them by e-mail. Out of a total of the 88 identified companies, we received 22 answers. Therefore the response rate is 25%.

The questionnaire consisted in a total number of 18 half-open and closed questions, including single-choice, multiple-choice and matrix questions. The first 3 questions of the questionnaire regarded the profile of the respondents, while the remaining 15 questions approached issues regarding (1) satisfaction with audit services and the current auditor, (2) the audit quality, (3) audit committee and its role and (4) the relationship between the frequency of auditor change and the performance of the audited entity measured through the variables: audit opinion and quality of the result disclosed.

² The rotation of the auditor increases the performance of the audited entity by increasing the quality of the reporting set measured through the number of disclosed note and/or the number of pages of the same notes related to the Financial Statements

Results

As we have already stated in the introduction, the hypothesis from which we started this study is the following: The audit quality increases under the mandatory auditor rotation.

Although our study continues and supports previous research in the field, we consider it valuable due to the perception of PIE's representatives. Considering that the first mandatory auditor rotation will take place in 2026, at the moment there are no real facts which can be analysed. Therefore from our point of view, the only way to add value related to this topic is by focusing on analysis the literature review and also by investigate the perception of the persons involved in this process.

The questionnaire structure is the following:

The respondents profile

This research focused only on respondents who are in charge with Governance according with Law 31/1990, namely the Board of Directors, Supervisory Board, Top management and Executive management. The most respondents are part of executive management (59%) or top management (37%). However, none of the survey's respondents are members of Audit Committees. Regarding their experience, 64% of respondents have a cumulative work experience less than 15 years, 32% of respondents said they have accumulated between 15-25 years of work while only one respondent gained an experience higher than 25 years.

Satisfaction with audit services and the current auditor

Regarding the satisfaction related to services provided by the external auditor, the most of respondents (86%) have evaluated them as exceed expectation, while 14% of them consider that the audit services meet some expectations. Moreover, 91% of respondents would like to continue the collaboration with the actual auditor.

The audit quality

To the question "what is your opinion regarding the relationship between the mandatory rotation of auditors and the quality of the audit process", 82% of respondents consider that mandatory rotation of auditors increases the audit quality, while 14% said that the mandatory rotation of auditors does not influence the quality of the audit. Only one person argues that the mandatory rotation of auditors reduces the audit quality.

The regulatory framework related to the mandatory rotation of auditors

More than half of the respondent companies have a section dedicated to this topic in their internal policies manual. Regarding the period of contracting of the audit services the responses obtained are straightforward, the respondents argue they negotiate the audit services on an annual basis, while the cumulative periods with the same auditor vary a lot, starting from 1 year to 7 years. Therefore we are not able to conclude a trend related to the auditor's tenure. However, most of the respondents (73%) have knowledge about the maximum legal period of contracting audit services with the same provider.

The audit committee and its role

As part of the new rules established by the audit reform, the private interest entities have to set an audit committee whose main responsibilities have been presented on the literature review's phase.

However, only 64% of respondents argue that they received the letter from the external auditors in the last 3 years. The remaining negative responses could be explained by the fact that a significant percent of responses were provided by the top management, which according with the

regulation stated by the Law 31/1990, it exercise its powers under the supervision of the supervisory board.

In terms of relevance, the majority of the respondents consider that the issues disclosed in addition to the audit opinion were more relevant to the management of the Company.

Another sensitive aspects we have investigated was related to the role of the Audit Committee. We requested our respondents to evaluate the main responsibilities of the Audit Committee which were established by the EU audit reform. Based on the respondents opinion, the Audit Committee offers effective oversight of the performance, independence and objectivity of the auditor and the quality of the audit. We noticed that the questions related to the non services audit have received the lowest ratings, while monitoring the auditor independence, (re)-appointment of statutory auditors and extending the tenure of the auditor received the highest ratings. In other words, we can affirm that Audit Committee ensures the independence of the auditor. Also, respondents consider that the insufficient time and the low level of the budget are the main reasons which lead to nonfulfillment of the EU audit reform's request.

The summary of the results can be seen on the table below.

Table 1

The extended role of the audit committee and related activities in the with external audit

Activities performed by the Audit Committee	Actual average ratio	Estimated max ratio (22*5=110)	Variation [abs]	Weight [%]
Monitoring the level of audit fees	90	110	(20)	82%
Evacuity of compliance for allowed non audit services	89	110	(21)	81%
Non audit services approval allowed	90	110	(20)	82%
Issuing guidelines and policies	89	110	(21)	81%
(Re)-appointment of statutory auditors	91	110	(19)	83%
Extending the tenure of the auditor	92	110	(18)	84%
Monitoring the auditor's independence	95	110	(15)	86%
Total	636	770	(134)	83%

Source: own projection

The relationship between the frequency of the change of the statutory auditor /audit firm and the performance of the audited entity measured through the variables: audit opinion and quality of the result disclosed.

The last section investigated aims to the relationship between the frequency of the change of the auditor and the performance of the audited entity. In order to check if there is a connection between them we asked our respondents how many auditors have audited the financial statements of their employer in the last 10 years. 41% of public interest entities have been audited by two auditors in the last 10 years, 32% of them by a single auditor and only for 23% of the entities the auditors changed 3 times in this period. One entity has been audited by 4 auditors in the last 10 years.

We noticed that most of respondents (82%) consider that mandatory audit rotation increases the audit quality, a small part of them (14%) consider that mandatory audit rotation does not influence the audit quality while only one respondent considers that mandatory audit rotation reduce the audit quality. In order to gain a better understanding on this topic, we performed a correlation between the frequency of the auditor change and the respondents opinion related the influence of the mandatory rotation of auditors. The results obtained revealed the fact that the most respondents who

consider there is a positive effect between the mandatory rotation of auditors and audit quality are employees of companies which have been audited of one or two auditors.

More details has been summarised in the table below.

Table 2

The correlation between the frequency of the change of the auditor and the perception of respondents related to the audit quality

Frequency of the change of the auditor in the last 10 years	Mandatory rotation of auditors does not influence the audit quality	Mandatory rotation of auditors reduces the audit quality	Mandatory rotation of auditors increases the audit quality	Total
One auditor	0	0	7	7
Two auditors	1	1	7	9
Three auditors	1	0	4	5
Four auditors	1	0	0	1
Total	3	1	18	22

Source: own projection

The respondents who argue they didn't change the auditor in the last 10 years were asked for their personal opinion related to the hypothesis we have tried to validate. 14% of the respondents consider that the rotation of the auditor does not influence the performance of the audited entity which could be measured by the nature of the audit opinion, while the rest of the respondents responses are divided in equal parts between both the positive and negative conclusion. 43% of respondents argue that the relationship between the frequency of the change of the auditor and the performance of the audited entity can be measured by the nature of the audit opinion while 43% of respondents argue that the relationship between the frequency of the change of the auditor and the performance of the audited entity can't be measured by the nature of the audit opinion. The same conclusion was obtained for the hypothesis that the frequency of the change of the auditor and the performance of the audited entity can be measured through the quality of the result disclosed on the notes related to the financial statements. Based on the responses received from companies which have been audited by the same auditor in the last 10 years we can affirm that no relationship could be identified between the mandatory auditor rotation and the audit opinion or the quality of the result disclosed.

The respondents who argued they changed the auditor at least once in the last 10 years were asked whether the audit opinion has changed with the auditor change. They were 15 respondents in this case, out of which only one argued that the audit opinion has changed after the change of the auditor. 93% of the respondents argued that the audit opinion hasn't changed with the auditor change. Regarding the relationship between the change of the auditor and the quality of the result presented, we have asked our respondents about the number of notes related to financial statements and/or the extent of notes as number of pages. 13% of the respondents said they noticed an increase of the quality of the result disclosed, measured both through the number and details of the notes related to the financial statements. 74% of the respondents argued that they didn't notice any changes related to the result disclosed on the notes. The remaining respondents argued that the notes related to the financial statements change due to the IFRS request or due to the predefined template used by the Big 4 firm appointed by the auditee's shareholders to perform the external audit.

Conclusions

A key aspect in the regulation of auditing is whether to mandate the rotation of audit firms. In order to reflect credibility and transparency, the opinion issued by the external auditors aims to

ensure the quality of financial statements, in all material aspects and strengthen the confidence in the management team. The role of the Audit Committee is to improve the quality of results presented by financial statements, which is very useful for all stakeholders involved especially in the field of financial reporting. Therefore, the role of the audit committee is extremely important within the entity, mainly in the prevention of corporate scandals that have led over the years to the bankruptcy of a number of Companies.

Is mandatory auditor rotation a prerequisite for increasing the audit quality and achieving the objectives established by the EU audit reform for the public interest entities? The answer to this question is a topic of great interest in literature, being debated by many researchers in the field, due to the importance of this concept nowadays. Our study examined the relationship between auditor's rotation and audit quality measured by the nature of the audit opinion and by the quality of result disclosed in the notes related to the financial statements, given the perception of 22 entities listed on Bucharest stock exchanges from Romania. By using a survey based on a questionnaire, we reached to a response rate of 25%. The inquiry performed revealed that the mandatory rotation of auditors increases the quality of reporting in audit. However, no relationship could be identified between the mandatory rotation and the audit opinion. Finally, we noted that the financial reporting statements suffer changes rather due to IFRS request or operational and financial activity of the auditee than to the auditor's rotation. Nevertheless, our research has limitations. Our investigation relied on responses collected from a relatively small number of companies listed on BSE. Therefore, future research directions may target larger data series in terms of the number of respondents under investigation, as well as other audit quality measurement indicators and methods of data collection. Despite this limitation, we consider that our study contributes to the literature in two perspectives. The first one refers to the fact that it studies the relationship between mandatory audit rotation and audit quality in order to restore public trust in corporate reporting. The second one refers to the analysis performed in order to measure the audit quality through the main indicators identified in the literature: the nature of the audit opinion and the quality of the result disclosed through the notes related to financial statements.

Acknowledgments

I would like to thank Prof PhD. Habil. Bunget Ovidiu Constantin, Conf PhD. Dumitrescu Alin Constantin, Associate Prof PhD. Blidisel Rodica, Associate Prof PhD. Dumitrescu Diana from Faculty of Economics and Business Administration from Timisoara for all their guidance and to my mentor Efros Ion, Senior Manager at Deloitte Romania for his insightful comments.

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