Mandatory audit firm rotation in Spain: a policy that was never applied

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Abstract

Purpose – In recent international debates on auditing regulation, Spain has assumed a real prominence as a claimed practical example of where a policy of mandatory audit firm rotation did not work and was duly abolished. This study aims to provide an analysis of the implementation and subsequent removal of mandatory audit firm rotation in Spain in the 1990s.

Design/methodology/approach – This takes the form of historical analysis; the evidence in the paper derives from congressional hearings, financial newspapers and documents produced by the professional associations of auditors in Spain.

Findings – This paper demonstrates that at no stage was mandatory rotation of audit firms ever enforced on Spanish auditors. Further, the revision and subsequent removal of the Spanish law on mandatory audit firm rotation emerge as a rather politicized process, with no evident reference being made in the process of legislative reform to Spanish auditing experiences. The analysis also reveals that at the very time that Spain was being cited internationally for rejecting mandatory audit firm rotation, Spanish political parties and regulators were debating whether to "re-introduce" such a regulation.

Originality/value – The clear implication of the paper is that considerable caution needs to be taken in today's international-auditing arena, when analyzing the standpoints and claims made by professional associations and the evidence they provide to support their arguments for and against regulatory reform.

Keywords Auditing, Regulation, Spain

Paper type Research paper

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Introduction

The post-Enron era has witnessed a growing concern with issues of auditor independence and audit quality. The mandatory rotation of audit firms after a fixed period of tenure has again been suggested as an important way by which auditor independence could be enhanced (for a review, Catanach and Walker, 1999). The auditing profession and its regulators in different countries have been addressing and responding to claims that such a requirement would help to avoid the type of high profile corporate collapses and cases of audit failure of recent years (ICAEW, 2002; Moizer, 2003; FEE, 2004).

Calls for a mandatory rotation policy traditionally emphasize its potential to restrict managerial threats to change "non-compliant" auditors (Craswell, 1988; Petty and Cuganesan, 1996; Lennox, 2000) and prevent the excessive familiarity that may erode audit quality (Deis and Giroux, 1996; Raghunanthan *et al.*, 1994; Zeff, 2003; Francis, 2004). Typical counter-arguments are that auditors have economic incentives to maintain their independence and that audit quality may be lower for new engagements due to the lack of auditor knowledge of the client (Johnson *et al.*, 2002; Francis, 2004, p. 356).

With auditing firms and professional bodies, post-Enron, generally coming out against the introduction of mandatory audit firm rotation, much has been made of Spanish experiences with such a regulatory provision – with Spain being regularly cited in a wide range of academic papers, professional reports, and public speeches by national and international representatives of the accounting profession and auditing firms as a practical example of where mandatory audit firm rotation did not work. For instance, mandatory audit firm rotation in Spain has been held to have had a negative impact on the quality of auditors' work and on the structure of the audit market (Arruñada and Paz-Ares, 1995, 1997; ICAEW, 2002; FEE, 2004). The rotation policy was incorporated in the 1988 Spanish Audit Law, requiring mandatory rotation of audit firms every nine years. Its subsequent removal in 1995 has been classified as a "rational" decision by regulators after verifying that the rotation rule "did not work" and "did not achieve its objectives of public policy" (US House of Representatives, 2002, p. 20).

This paper demonstrates that the experience in Spain has been rather different and somewhat more complex than the above statements imply. For instance, despite the claims from representatives of the accounting profession at international level, it is very clear from our historical analysis that at no stage was the mandatory rotation requirement enforced on Spanish auditors – i.e. Spanish audit firms did not in practice have to rotate in a statutory, mandatory fashion. Under the Spanish Audit Law, the rotation requirement was to apply for the first time to audit assignments starting in 1988, meaning that the first mandatory changes of audit firms would have had to have taken place in 1997. The regulation, however, did not survive this long, having been formally abolished in 1995. Accordingly, instead of the "traditional" view portrayed by the international accounting profession of an experiment that did not work, mandatory audit firm rotation in Spain is more accurately regarded as a policy that was never given the chance to work. Indeed, the analysis presented in this paper suggests that the removal of the Spanish law on mandatory audit firm rotation was a fairly politicized process, with legislative changes appearing to have had only a very loose connection with professional audit practice – a position reinforced by the way mandatory audit

firm rotation was reconsidered as a potential reform by Spanish politicians in 2002 at the very time that Spain was being held out internationally as a country that abolished such a regulation on grounds of practical experience.

Our research lends empirical support to the claim that regulation in accounting and auditing is a "much more precarious process than suspected" (Fogarty *et al.*, 1997, p. 181). The Spanish experience – and the way it has been used (or misused) in international debates on audit regulatory reform – also backs up the arguments of those who have questioned the transparency and accountability of professional and regulatory arenas and highlighted the growing influence of the multinational big four firms on policy processes (Cooper *et al.*, 1998; Caramanis, 2002). Additionally, the paper highlights how academic research can be used in an opportunistic fashion by regulators and professional bodies to block or promote certain reforms. The Spanish case certainly emphasizes that claims emanating from professional accounting circles need to be treated with a good degree of care and that careful, independent research has an important role to play in terms of opening up today's international audit policy arena to critical, but constructive analysis. Finally, although Spanish academic accounting research is assuming a growing international prominence, this paper, by seeking to get "inside" Spanish auditing and regulatory circles, illuminates the array of questions that still need answering regarding the development and internationalization of auditing practice in Spain and the degree to which Spanish accounting firms, their auditing approaches and traditions as well as the general regulatory approach is changing.

The paper is organized into six subsequent main sections. The second section demonstrates the way in which the Spanish experience has been referenced in recent national and international debates on mandatory audit firm rotation. The third section provides a brief account of the history of auditing regulation in Spain and explores in detail the process by which mandatory audit firm rotation was originally established in Spain in 1988. The fourth section examines Spanish experiences with such a legislative requirement between 1988 and 1995. During this period (in 1991) there was a formal change in the interpretation of the law with respect to existing auditor tenure contracts and the subsequent repeal of the mandatory audit firm rotation requirement in 1995. The fifth section analyses the most recent (2002) attempt to establish mandatory audit firm rotation in Spain while the final section, in closing the paper, reflects critically on what can be learned from the Spanish experience with mandatory audit firm rotation and how it develops the existing literature on international auditing regulation.

The global significance of Spanish experiences with mandatory audit firm rotation

The collapse of Enron and its auditors, Arthur Andersen, quickly led regulators worldwide to consider different mechanisms for enhancing auditor independence. The auditing profession has traditionally opposed the implementation of any mandatory regulatory requirement for audit firms to rotate after a given period of tenure (for reviews, ICAEW, 2002; FEE, 2004). What was interesting about the post-2001 regulatory debating arena was that arguments against mandatory audit firm rotation were not just made on academic or a priori grounds. They were frequently rooted in supposed practical experience, with Spain being highlighted as a clear case where such a rule did not work. The following paragraphs illustrate how the Spanish experience

has been used by regulators, professional associations and international auditing firms worldwide to support their stance against mandatory audit firm rotation.

In the UK, the Co-ordinating Group on Audit and Accounting Issues (CGAAI) set up in February 2002 by the Secretary of State for Trade and Industry with the purpose of reviewing the UK's current regulatory practices for statutory audit and financial reporting, highlighted the Spanish case as an illustration of the failure of mandatory audit firm rotation:

> There is no strong evidence from Italy (which requires audit firm rotation every nine years for the 20 listed companies) or Spain (which abandoned a similar requirement for listed companies in 1995) of a positive impact on audit quality…
>
> In Spain, it was found that mandatory rotation reduced the incentive to improve audit quality and increased the number of first time audits with corresponding loss of accumulated audit knowledge (Final Report of the CGAAI to the Secretary of State for Trade and Industry and the Chancellor of the Exchequer 29 January 2003; CGAAI, 2003, pp. 26, 75).

Parliamentary discussions concerning mandatory rotation of audit firms also highlighted the Spanish case:

> … certainly all our studies to date suggest that audit firm rotation does not work, certainly international experience suggests that it does not work, in countries like … Spain … (C. Reeves CBE, Director, The Review Board, in discussing the Memorandum submitted by The Review Board, the Auditing Practices Board and the Ethics Standards Board of the Accountancy Foundation; Minutes of Evidence Treasury Committee, 25 June 2002. Question and answer 206. UK House of Commons, 2002).

In the USA, the President of the American Institute of Certified Public Accountants (AICPA) in a speech to the House of Representatives referred to the Spanish case as a supportive example of the claim that audit firm rotation does not achieve its public policy goals:

> Finally, I must mention that at one time Greece, Spain and Italy all required mandatory auditor rotation. Greece and Spain dropped the requirement after determining that the concept did not achieve public policy goals (Mr B. Melancon, President and CEO, AICPA, Committee on Financial Services, 13 March 2002. US House of Representatives, 2002).

In New Zealand, the submission by the Institute of Chartered Accountants of New Zealand to the Securities Commission on Corporate Governance Principles, pointed out, in discussing mandatory audit firm rotation, that:

> Of the three countries that had tried audit firm rotation, Italy, Spain and Turkey, only Italy has persevered with it … (Submission to the Securities Commission Corporate Governance Principles; Institute of Chartered Accountants of New Zealand November 2003, p. 19).

Professional associations have also used the example of Spanish practical experience with mandatory audit firm rotation to reject the implementation of such rule – a post-Enron example being the July 2002 report by the Institute of Chartered Accountants in England and Wales (ICAEW, 2002) summarizing the current requirements for rotation in different countries and the main results of academic research on mandatory audit firm rotation Gendron and Bédard (2001) argued that the use of academic research may help the auditing profession to maintain the legitimacy of its claims in the eyes of the government and public. In particular, rather than

providing an objective description of the circumstances surrounding the implementation of a regulatory provision in a particular setting and a fair evaluation of all relevant academic research, professional bodies may seek to avoid "threatening research" (Gendron and Bédard, 2001) and give an account of events and results that fits their interests. There are some suggestions of such behavior in the way in which research on the Spanish experience with mandatory audit firm rotation has been reported by professional bodies. For instance, the above mentioned report by the ICAEW analyzed in detail the results of two academic studies – one carried out in Italy (SDA Universitá Bocconi, 2002) and one in Spain (Arruñada and Paz-Ares, 1995). Both studies were reported as providing empirical evidence against audit firm rotation, on the basis that they demonstrated that such a regulatory policy imposes "significant additional costs" on the audit firms and auditors and has "adverse effects on audit quality in the early years of the appointment" (ICAEW, 2002, p. 1). However, the Bocconi report (SDA Universitá Bocconi, 2002) and an academic paper based on such research (Cameran *et al.*, 2003) present a rather different conclusion to the one reported in the ICAEW report on the impact of mandatory audit firm rotation in Italy[1]. For instance, it is clearly acknowledged that corporate managers, internal auditors and external auditors "generally agreed that the current mandatory audit rotation rule constitutes a mechanism to guarantee auditor independence" (SDA Universitá Bocconi, 2002, p. 8; Cameran *et al.*, 2003, p. 4). It is also stated that "the mandatory audit rotation rule does not seem to have had much impact on the level of competition in the mandatory audit segment" (SDA Universitá Bocconi, 2002, p. 3; Cameran *et al.*, 2003, p. 5). In fact, the level of concentration reported is similar to that reported for other countries (Pong, 1999 for the UK position; Carrera *et al.*, 2005 for Spain; Wolk *et al.*, 2001 for the US). Regarding the impact of such a rule on audit costs, the Bocconi researchers found that most interviewees believed that the costs of switching auditors either had not changed or had even dropped as a consequence of mandatory audit firm rotation. Finally, they found that 69 percent of managers approved of mandatory audit firm rotation while only 14 percent had a negative view of such a requirement. Moreover, many external auditor respondents (69 percent) indicated that a more frequent audit firm rotation requirement would have a positive impact on auditors' independence (SDA Universitá Bocconi, 2002, p. 7). To sum up, although the authors of the Bocconi study did believe that mandatory rotation "risks being simply a 'persuasive' solution to the problem of independence" (SDA Universitá Bocconi, 2002, p. 8; Cameran *et al.*, 2003, p. 8), the empirical evidence provided indicated that mandatory audit firm rotation was widely accepted by a range of different actors in the Italian audit market.

Questions can also be directed at the ICAEW's reliance on the Arruñada and Paz-Ares (1995) study in concluding that the mandatory rotation of audit firms in Spain has had a negative impact on audit quality. The main purpose of the work by Arruñada and Paz-Ares was to evaluate, in terms of efficiency, the system of obligatory audit firm rotation in Spain. They used mathematical modeling and computer simulations to demonstrate that mandatory audit firm rotation could harm auditor independence and may have a negative impact on the audit market. However, at no stage in their work did they draw directly on any empirical evidence from the Spanish audit market to make or support such a viewpoint and, accordingly, the study is more accurately regarded as a theoretical piece of work assessing the possible

consequences of audit firm rotation in Spain but not one that can be represented as providing any conclusions on the actual, practical impact of mandatory audit firm rotation in Spain.

Such matters of detail or complexity did not stop the Fédération des Experts Comptables Européens (FEE, 2004) from relying on such work (and other country studies, including the conclusions presented by the CGAA in the UK) in choosing to reject the policy of mandatory audit firm rotation. Spain was clearly highlighted in FEE's (2004, pp. 6, 14) report as an example of the negative impact of such a regulation:

> In Spain, the Statutory Audit Law of 1988 introduced mandatory rotation after a maximum period of nine years with a prohibition to take up the same audit engagement before at least a three-year period has elapsed. The Limited Liability Partnership Act of 1995 removed such prohibition and in fact abolished the mandatory rotation requirement. Subsequently, the Spanish Government funded the Arruñada and Paz-Ares [...] report which supported this decision.
>
> There is no strong evidence from Italy (which requires audit firm rotation every nine years for the 20 [audit firms of] listed companies) or Spain (which abandoned a similar requirement for listed companies in 1995) of a positive impact on audit quality.

The vast majority of the top 30 accounting firms in countries such as the UK also rejected audit firm rotation as a legitimate post-Enron regulatory reform (*Accountancy Age*, 9 January 2003, p. 14). Again, Spain was cited to support the case against mandatory rotation but without any attempt to analyze its empirical experience:

> Only in Italy is audit rotation currently mandatory... Spain had a similar provision but has recently withdrawn it. The conclusion is a compelling one: mandatory audit firm rotation is a bad idea (PricewaterhouseCoopers, 2002).

Finally, the Government Accountability Office of the US (GAO (2003, p. 86)) in its report on mandatory rotation of audit firms noted that, "from 1989 through 1995, Spain had a mandatory audit firm rotation requirement with a maximum audit term of 9 years." The report relied on comments made by the Director of the *Comisión Nacional del Mercado de Valores* (CNMV), the Spanish agency in charge of the stock markets, in identifying the reasons why the rotation requirement was abandoned:

> ...it was removed because]the main objective of increased competition among audit firms had been achieved and because of listed companies' increased training costs incurred with a complete new team of auditors from a new public accounting firm (GAO, 2003, p. 86).

However, as with other studies, the report did not mention that the mandatory rotation rule was removed before any company or audit firm in Spain was legally required to comply with it.

The Spanish legal position with respect to mandatory audit firm rotation has been accurately stated in a limited number of academic papers (Catanach and Parker, 1999; Moizer, 2003; Ng, 2003; Zeff, 2003). Both Zeff (2003, p. 2, footnote 3) and Moizer (2003, p. 16) note that Spanish auditors did not have to rotate in a mandatory fashion because the rule was removed before the statutory maximum length of a post-1988 Spanish audit engagement had been exceeded. Ng's (2003, p. 2) historical review of the concept of mandatory audit firm rotation also refers to the Spanish experience as one where the policy was abandoned after a trial period, but did note (albeit without explanation) that the legislation was repealed before it would have had an impact[2]. Despite such

references, there has been no detailed analysis of what really happened in Spain and why the audit firm rotation requirement was removed.

Our starting point with this paper, therefore, is to clarify the nature of Spanish experiences with such a regulatory policy. Contemporary accounting historians (Mills, 1990; Parker, 1999; Previts *et al.*, 1990; Lee, 1995; Carnegie and Napier, 1996; Chandler and Edwards, 1996; Funnell, 1996, 1998) have demonstrated the value of providing alternative histories which challenge the accepted or assumed historical position and the case of mandatory audit firm rotation in Spain is no exception in this regard. At a very basic level, it demonstrates clearly that Spain cannot be held up as a proven practical example of the failings of mandatory audit firm rotation. At another level, tracing through the introduction, revision, removal and attempted re-introduction of such a regulatory policy in Spain highlights the political nature of audit regulatory processes in Spain and also casts additional light on the professional status of auditors in Spain. Finally, the case allows for an assessment of the broader significance of Spanish experiences having been so fundamentally misrepresented on the international regulatory stage. In particular, it is important to consider what such misrepresentation says about the role and significance of independent academic research – and how best to treat (and respond to) the "expert" views of professional accounting associations and the large, international audit firms on the nature of their operating environment and the efficacy of existing and proposed regulatory provisions.

Audit regulation in Spain and the introduction of mandatory audit firm rotation

The commencement of Spain's membership of the European Union (EU, then the European Economic Community, EEC) in January 1986 was influential in shaping several of its financial reporting reforms (Bougen and Vázquez, 1997; Ruiz-Barbadillo *et al.*, 2000). For instance, the Spanish Audit Law, enacted in 1988, was a direct response to EEC/EU company law directives and established, among other things, mandatory audits for medium- and large-sized companies. Before 1988, only a few companies, such as state-owned companies and firms in regulated industries, had had compulsory audits. Some companies voluntarily chose to have their financial statements audited, with the main professional association of auditors in Spain at that time, the *Instituto de Censores Jurados de Cuentas de España* (ICJCE), publishing in its annual reports (between 1973 and 1985) the number of audits performed by members of ICJCE together with a list of those limited companies whose financial statements had been audited[3].

The debate on the 1988 Audit Law in the Spanish parliament focused mainly on the recognition and regulation of audit professionals (Bougen, 1997; Ruiz-Barbadillo *et al.*, 2000). The ruling socialist party *Partido Socialista Obrero Español* (PSOE) proposed an interventionist model, with a new statutory regulatory body in the form of the *Instituto de Contabilidad y Auditoría de Cuentas* (ICAC) – the Accounting and Auditing Institute with considerable capacity to monitor the work of auditors (García-Benau and Humphrey, 1992; Ruiz-Barbadillo *et al.*, 2000). For PSOE, auditing was regarded more as an activity than a profession and as such was not really seen to be something capable of justifying professional claims for self-regulation (Bougen, 1997; Bougen and Vázquez, 1997; Ruiz-Barbadillo *et al.*, 2000). The opposition *Partido Popular* (PP) party,

however, demanded a self-regulated audit profession governed by the three existing professional associations of auditors – ICJCE, *Registro de Economistas Auditores* (REA) and *Registro General de Auditores* (REGA). The parliamentary majority enjoyed by PSOE ensured that the 1988 Audit Law encompassed its proposals and ICAC was duly established. ICAC's powers included, among other things, responsibility for a disciplinary regime for auditors, the capacity to investigate audit work performed by registered auditors, and the adaptation of audit legislation to EU directives (García-Benau and Humphrey, 1992; Ruiz-Barbadillo *et al.*, 2000, pp. 123-4). The 1988 Audit Law did not take into account the claims of professional associations of auditors and did not assign rights or historical privileges to any of the three existing associations.

The 1988 Audit Law established the requirement for mandatory audit firm rotation. Prior to this law, there had been attempts to introduce an obligatory change of audit firms – with the draft of the Limited Companies Act in 1975 (*Anteproyecto de Ley de Sociedades Anónimas*) and the draft of the Accounting and Auditing Reforms in 1983 (*Anteproyecto de Reforma Contable y Auditoría*) both including a requirement for rotation of audit firms. However, neither of these projects became law with typical reasoning for such a lack of development being that the EEC, at that time, was in the process of publishing new company law directives – directives "... to which Spain would have to adapt sooner or later, and therefore it was better to wait and see" (Casanovas Parella, 1992, p. 172; quoted in Bougen and Vázquez, 1997, p. 3).

The draft 1988 Audit Law (*Proyecto de Ley de Auditoría de Cuentas*, 121/000054, October 20, 1987) proposed a system of mandatory audit firm rotation whereby the audit firm's appointment would last for no less than three years and no longer than nine years (art. 8.4). Under such a proposal, once the audit firm's appointment had terminated, it would have to be replaced and could not seek reappointment until a further three years had passed. Once the appointment was approved by the Annual General Meeting[4] it was irrevocable unless a fair cause (*causa justa*) arose – although the audit legislation did not define what fair cause meant. During the subsequent parliamentary debate, opposition parties showed their disagreement with such a proposal. Some parties (such as PP) supported a more severe rotation measure, while others such as *Convergència i Unió* (CiU) demanded the removal of any requirement for compulsory change of auditors. In particular, PP argued for mandatory audit firm rotation every three years. Interestingly, this proposal was endorsed in the parliamentary debate by Mr Pont Mestres, who was at that time the president of the leading association of auditors, the ICJCE. The argument to support such a proposal was that:

> [The rotation of audit firms every three years will] ensure auditors' independence ... and avoid the concentration of financial information in the hands of few large auditing firms ... (Enmienda núm. 45, Boletín Oficial de las Cortes Generales, III Legislatura, Serie A. Núm. 53-55, December 3, 1987).

Other parties, such as CiU and *Partido Liberal*, attempted to avoid the implementation of any kind of restriction on the length of the audit firm's engagement. CiU, the dominant party in Catalan regional politics and the third largest parliamentary group in the Congress of Deputies at that time (Morlino, 1995, p. 344), demanded that the length of the contract should be for a minimum of three years and a maximum of six years, with the reappointment of the auditor being possible after the contract period

had been completed. CiU relied on European Directives and the exceptional nature of the Italian case (the only European country where rotation of audit firms was mandatory) to justify the proposal, stating that:

> Our amendment is in accordance with the draft of the Fifth Directive of the EEC . . . After six years of an auditor-auditee relationship, a time for reflection may be recommendable. However, it should not imply a mandatory break in the professional relationship (Enmienda núm. 133, Boletín Oficial de las Cortes Generales, III Legislatura, Serie A. Num. 53-55, December 3, 1987).

The parliamentary majority enjoyed by PSOE again ensured that all of the proposals made by the opposition parties were rejected. The result was a mandatory audit firm rotation requirement that could technically apply any time between three and nine years after the start of the audit firm's tenure (depending on the precise form of the auditor's contract). That is, once the initial contract expired, the Annual General Meeting of shareholders must appoint a new auditor.

A short-lived regulation: the revision and subsequent removal of mandatory audit firm rotation

In the early 1990s, the public reactions of Spanish auditing firms regarding the rule of mandatory rotation were not homogeneous. While the then chairman of Arthur Andersen in Spain noted, rather disparagingly, that the rule was "like a Mediterranean disease" (making reference to the cases of both Spain and Italy – see *International Accounting Bulletin*, 1983, p. 2, April 5), some audit firms were reported as seeing positive aspects in such a regulatory requirement. This viewpoint tended to relate directly to the potential opportunity to secure new audit clients (for example, a partner at Ernst & Young at that time said that "the smaller Big Six firms and larger mid-tier firms could benefit from the rotation, but only in the short-term" (*International Accounting Bulletin*, 1983, p. 2, April 5)). Generally, the claims of professional associations to remove the policy of rotation did not rely on detailed arguments or analysis of the Spanish audit context – the basic claim was that "the rule must be wrong" because it had only been implemented in just one other European country, Italy (Durández, 1991; López-Combarros, 1996).

Two empirical studies carried out at that time (García-Benau *et al.*, 1993; Prado-Lorenzo *et al.*, 1995) showed that mandatory audit firm rotation was not well regarded by the Spanish audit profession – although it was something that had not been objected to at the time of the debate of the Audit Law in 1988 and had, in fact, been supported by the then president of ICJCE. García-Benau *et al.* (1993) compared the views on the nature and standard of auditing practice in Britain and Spain. Perceptions of auditors, financial directors and users of corporate financial statements were obtained from two questionnaire surveys covering a range of issues including their opinions of mandatory audit firm rotation. The findings revealed that British auditors were strongly against rotation of audit firms (80 percent of auditors disagreeing with such a proposal). In Spain, a significantly lower but still clear majority of auditors (59 percent) were against such policy (García-Benau *et al.*, 1993, p. 300). Prado-Lorenzo *et al.* (1995) analyzed the perceptions of Spanish auditors about mandatory rotation by using data collected from questionnaires. Both individual auditors and members of audit firms rejected any restriction on auditors' reappointment (Prado-Lorenzo *et al.*, 1995, p. 653).

The pressure for reform was driven in the early 1990s by the fact that a substantial number of audit contracts were due to end[5]. Traditionally, auditing had not been extensively practised in Spain (García-Benau and Humphrey, 1992), resulting in companies subject to statutory audits for the first time acting "prudently" and only engaging auditors for the minimum three-year period (Petit, 1995). There were suggestions, though, that such initial prudence was seen to have been excessive, with the various start-up costs associated with a new auditor (following the mandatory change) not necessarily being seen as desirable (Petit, 1995). There were also concerns over the practical feasibility of switching many audit firms:

> The first three-year term mandated by the Spanish audit law of 1988 has expired, and leading firms are awaiting a bureaucratic nightmare as some of the rules are found to be unclear and unworkable (*International Accounting Bulletin*, 1983, p. 2, April 5).

The response of the profession was to demand extensions to the three-year appointment period – up to the maximum length of nine years – and thereby delay the implementation of rotation (*Expansión*, October 21, 1993; *Expansión*, October 25, 1993; *Expansión*, October 28, 1993). The particularities of the Spanish audit market could potentially be held to have contributed to the aura of uncertainty as to what would happen if rotation was applied. For example, according to available statistics, in 1995 42 percent of audit firms in Spain (companies and self-employed professionals) had only one client, while 76.4 percent had less than five clients (*Expansión*, February 22, 1995). In these circumstances, mandatory audit firm rotation would trigger a significant diminishing in the portfolio of such audit firms, particularly if they failed to secure new audit clients.

In pursuing extensions in audit contracts, the professional auditing bodies focused on what they argued was an imprecise and ambiguously worded article 40.1 of the Audit Law (Royal Decree 1636/1990 of December 20). They argued that the Law had established a maximum number of years for the audit contract and, as such, any extension would not infringe the law so long as it did not exceed the maximum period of nine years (*Expansión*, January 25, 1992). Auditors in practice raised several questions with the regulatory body ICAC *Boletín Oficial del Instituto de Contabilidad y Auditoría de Cuentas* (BOICAC No 4, Consulta No 8 January 1991; BOICAC No 12, Consulta No 6 March 1993) regarding the legality of the extensions and the interpretation of the articles about audit firm rotation in the: Audit Law; Regulations of the Audit Law (*Reglamento de la Ley de Auditoría*, 1990); and the 1989 Companies Act (*Texto Refundido de la Ley de Sociedades Anónimas*). In January 1991, ICAC permitted such extensions, arguing that it was possible for the reappointment of the same auditor to be made after the termination of the (initial) contract as far as such an extension would not exceed the maximum of nine years (BOICAC No. 4, Consulta No 8 January 1991). In 1993, when auditors again raised a question about the possibility of reappointments, ICAC confirmed its position on such matter (BOICAC No 12, Consulta No 6 March 1993). With many contracts initially being signed for a period of three years, there was always going to be a likelihood that some companies would decide to change their auditors in 1993[6]. However, given ICAC's interpretation of the law, such changes can only be classified as voluntary ones – a result of the client's wish to replace its incumbent auditor – and not ones caused by any mandatory audit firm rotation requirement.

With the right to extend audit appointments until 1997 secured, the issue of rotation then seemed to go relatively quiet in Spanish auditing circles. Further, the audit market was showing an extraordinary rate of growth as a direct consequence of the implementation of the 1988 Audit Law and the 1989 Limited Companies Act which had made the external audit a mandatory requirement for many Spanish companies[7]. In these circumstances, Spanish audit firms generally did not appear to be under any imminent threat of a declining audit client base. The audit profession chose to focus its criticisms on apparently more contentious aspects of the 1988 Audit Law, especially with respect to the interventionist nature of ICAC and its policy of financially sanctioning audit firms found to have breached minimum audit quality standards[8].

Although some Spanish commentators did emphasize the need to remove mandatory rotation (Iglesias, 1994), there was no real public debate pressurizing regulators to make any such revisions to the Law. Internationally, two studies published in 1992 (Cadbury Committee Report, 1992; AICPA, 1992) highlighted the excessive costs of mandatory audit firm rotation and did not recommend it as a regulatory reform to be pursued in the UK and USA, respectively. The suggestions and conclusions of these reports were introduced in Spain, albeit with a certain delay, by academics (Arruñada and Paz-Ares, 1994, 1995; Gonzalo-Angulo, 1995; Prado-Lorenzo *et al.*, 1995). Arruñada and Paz-Ares (1994), drawing on international research, summarized the arguments against mandatory rotation. In subsequent studies (Arruñada and Paz-Ares, 1995, 1997), they sought to demonstrate theoretically that the start-up costs associated with a new auditor appointment were unacceptably high and outweighed the potential benefits of rotation. They also argued that the mandatory change of audit firms was not acceptable due to the negative effects on the audit market, with the regulation generating a less competitive market and, overall, leading to a decrease in audit quality. Similar arguments were provided by Díaz (1995), who pointed out that Spanish companies could hardly be expected to assume the increased audit costs caused by mandatory rotation when they were already under pressure to improve their international competitiveness given the prospect of a European market for audit services.

In January 1994, a draft of the Limited Liability Companies Act (*Ley de Sociedades de Responsabilidad Limitada*) was tabled in the Congress of Deputies[9]. During the debate in the Congress, there were no indications that this law was going to serve as a mechanism for removing mandatory audit firm rotation. The debate on the Act started on January 25, 1994 and was not completed until March 9, 1995, when the Act was finally approved by the Congress of the Deputies. Amendments to the draft were tabled between February 8 and May 7, 1994 but neither these nor the debate as a whole made any reference to the rotation policy. It was only in the subsequent debate in the Senate that the issue emerged – via two amendments put forward by CiU. Amendments 274 and 275 demanded a change to the articles directly related to mandatory audit firm rotation in the Companies Act and in the Audit Law. Specifically, CiU's proposal was that:

> ... auditors will be appointed for a given initial period of time which cannot be lower than three years or higher than nine years since the date of the first accounting year audited by the audit firm. They may also be reappointed[10] (Enmienda No. 275 Del Grupo Parlamentario Catalán en el Senado. Convergència i Unió. Boletín Oficial de las Cortes Generales V

> Legislatura. Serie 11. Proyectos de Ley 23 diciembre de 1994. Num. 53 (d). Num. Exp. 1211000034, p. 110).

To justify such a proposal CiU argued that it was concordant with the requirements of the draft of the 5th Directive of the (then) EC which allowed for the indefinite reappointment of auditors. Amendment No. 275 tabled by CiU was subsequently incorporated in the government's draft bill with one modification. Instead of allowing the reappointment period to be extended from anywhere between three and nine years, the draft approved by the Senate and sent (back) to the Congress of Deputies required auditors to be reappointed annually once the first appointment period had finished (*Disposición Adicional Sexta Ley de Sociedades de Responsabilidad Limitada*, 1995). Although there is no evidence in the discussions in the Senate and in the Congress of Deputies as to the reasons used to justify such a modification, the Spanish financial press (*Expansión*, January 26, 1995, p. 29) suggested that PSOE believed that the lack of a rotation requirement after the initial appointment period would not provide sufficient guarantees to other third parties affected by auditors' work. Accordingly, PSOE sought to avoid organizations/auditors getting tied into long-term engagements by imposing an annual reappointment process. In the final debate on the draft law in the Congress of Deputies, a PP representative, Mr Fernández de Trocóniz Marcos, was the only one to criticize the annual reappointment of auditors – arguing that sooner or later its reform would be demanded (because of social pressure or EU regulations) in order to allow companies to reappoint their auditors for, at least, a period of time similar to that of their first appointment (Diario de Sesiones, V Legislatura, Núm. 131 Sesión plenaria Núm. 129, 9 Marzo de 1995, p. 6947). The Limited Liability Companies Act, with the additional disposition No. 6 specifying the removal of mandatory audit firm rotation, was duly published in May 1995. Article 8.4 of the Spanish Audit Law and article 204.1 of the Companies Act were modified accordingly, such that:

> ... [auditors] will be appointed by a given initial period, which cannot be lower than three years nor higher than nine years ... They may also be reappointed (but only on an annual basis) once the initial period of appointment finishes (Disposición adicional sexta. Modificación de la Ley de Auditoría de Cuentas. BOE, 1995, p. 255).

It is quite clear from parliamentary documents that no Spanish political party expressed disagreement with the removal of rotation. The change in Spanish law on audit firm rotation also appears to have been approved without any explicit recognition being given to the views of key investors or other user groups, or even those of the main regulatory body, ICAC. Indeed, the then president of ICAC, Mr Ricardo Bolufer, publicly expressed his disagreement with such a decision and emphasised that it would now be necessary at least "to analyse the convenience of the rotation of audit partners and audit teams" following the Cadbury Committee's recommendations in the UK (*Expansión*, February 4, 1995, p. 34)[11].

What is probably most surprising with respect to the removal of mandatory audit firm rotation is that it came at a time when Spain had just experienced a number of major financial scandals. These scandals had raised serious questions over the effectiveness and independence of auditors, with regulators imposing some quite substantial fines on the major, international audit firms (García-Benau *et al.*, 1999;

Expansión, November 3, 1994, p. 3). For example, as a result of one of the most notorious financial scandals in Spain involving the financial institution Banco Español de Crédito (Banesto), Price Waterhouse was fined Pts 127 million (approx. 763,285 Euros – 3 percent of its annual fee income) by ICAC for its inadequate audit of Banesto's 1992 accounts and its report on the shares issue of the company in 1993 (García-Benau *et al.*, 1999, p. 706). Such incidents had brought discussions on the auditing expectations gap to Spain, a concept that, contrary to the situation in other countries such as the UK, had not had any prior operational significance in Spain (García-Benau and Humphrey, 1992, p. 312; García-Benau *et al.*, 1993; Arruñada and Paz-Ares, November 27, 1994, p. 29). It is rather ironic that one of the rules often held out as a potential way of reinforcing auditor independence vanished when the Spanish auditing profession was evidently struggling to satisfy social expectations in this regard.

There are some grounds for suggesting that the removal of mandatory audit firm rotation prior to its practical operation was more due to political convenience rather than regulatory ineffectiveness – a commodity exchanged for political support in the (political) market for legislative proposals (Gibbons, 1999, p. 135). The ruling socialist party (PSOE) had enjoyed a parliamentary majority when the Spanish Audit Law was enacted (and the rotation policy introduced) in 1988. However, following the 1993 general election, PSOE remained the governing party in Spain but no longer had a parliamentary majority – being reliant on the support of minority political parties. Post-1993, PSOE struck agreements annually with CiU in return for parliamentary support, thereby giving CiU some degree of influence over the main PSOE government agenda[12]. These agreements included considerable concessions for Catalonia but also commitments to greater overall budgetary stringency and labour market flexibility, in keeping with CiU's economic liberalist stance (Gibbons, 1999, pp. 105, 120-1). In terms of mandatory audit firm rotation, PSOE appears to have made a political agreement with CiU:

> The Socialist Group will support CiU's proposal to remove the requirement of mandatory rotation of audit firms every nine years from the draft Limited Liability Companies Bill [...]. By doing so, PSOE attempts to seek the support of CiU to approve a new regulation on "Employee-owned Companies" (*Expansión*, January 26, 1995, p. 29).

As noted in the previous section, CiU had expressed its disagreement with any kind of rotation policy when the draft of the 1988 Spanish Audit Law was first debated. However, it has been suggested that its 1994-1995 initiative on this issue was strongly influenced by pressures and demands made by the Spanish auditing profession. This was the reported view of a representative of CiU in an interview published in a professional journal (Díaz, February 10, 1995). From such a standpoint, the audit profession effectively took advantage of Spanish legislative procedures and the on going review of other (non-audit related) company law provisions to negotiate and put pressure on a political group (CiU) that it knew already had a positive attitude towards the removal of rotation (Amesti, 1995; Petit, 1995). Gonzalo-Angulo (1995, p. 617), a senior Spanish accounting academic, has also acknowledged such pressures, albeit without naming any political group:

> ... the discomfort of the auditing profession with the sword of Damocles of rotation policy has led, six years after the approval of the Audit Law, to new legislation to remove the

> mandatory rotation of auditors. The profession, by spreading their powerful tentacles, has received the support of certain parliamentary groups for the removal of a cumbersome, threatening and supposedly dangerous measure ...

The re-emergence of mandatory audit firm rotation as a regulatory solution

The Enron/Andersen affair, post-2001, has raised major concerns internationally about auditor independence, audit quality and the need for regulatory action. Although, the implementation of mandatory rotation of audit firms was considered by regulators in different countries such as the USA and the UK as a potential way to enhance the perception of independence of auditors, its implementation was generally not recommended on the grounds that its costs were said to exceed its benefits (GAO's (2003) Report on Mandatory Rotation in the USA, the Final Report of the CGAAI (2003) and the Report of the ICAEW (2002) on mandatory rotation in the UK). As illustrated earlier in this paper, Spanish experience was used to support such claims against rotation. However, what has never been reported in the international literature is that, at this very moment of international auditing crisis and debate, Spanish regulators were in fact considering whether there was a case for re-establishing mandatory rotation of audit firms.

This process started when, in March 2002, the Spanish Government[13] tabled, in the Congress of Deputies, a parliamentary bill entitled *Ley de Medidas para la Reforma del Sistema Financiero* (Measures for Reforming the Financial System Act) popularly known as *Ley Financiera* (Financial Law). Although, the Financial Law did not have among its objectives the desire to modify the regulatory framework of auditing[14], several parliamentary groups tabled amendments relating to mandatory audit rotation. Table I summarizes the different proposals presented in the Spanish parliament.

The government proposed to re-establish mandatory audit firm rotation every 12 years for listed companies arguing that this requirement would help "to ensure independence in the auditor-client relationship" (*Congreso de los Diputados, Enmienda* 168, May 17, 2002). The debate on legislative amendments in the Congress showed that the government took for granted that audit firm rotation had a positive impact on auditor independence (*Congreso de los Diputados, Diario de Sesiones*, 504, May 29, 2002, p. 16170). The government's representative in the parliamentary discussions of the Financial Act, Mr Cámara Rodríguez-Valenzuela, pointed out that:

> ... audit firm rotation is not a new subject and it has been discussed for many years internationally within professional auditing circles in countries such as the US ... (*Congreso de los Diputados, Diario de Sesiones*, 504, May 29, 2002, p. 16168).

This awareness of debate on the subject seemingly, however, did not extend to any acknowledgement of the criticisms that had been made internationally of mandatory audit firm rotation, nor did it generate any reference to the fact that such a requirement had only recently been removed in Spain. Such a proposal was immediately rejected by professional auditing bodies:

> ... the proposals made ... are more interventionist than the current rules (Mr J.M. Gassó President of the ICJCE; *Cinco Días*, May 9, 2002).

> Audit rotation issue should wait until Brussels recommendations (Mr L. Lara, President of the REGA; *Cinco Días*, May 9, 2002).

Date	Political group	Doc[a]	Mandatory rotation	Years[b]	Who rotates?	Which companies are subject to mandatory rotation?	Justification
Parliament							
March 8, 2002	PP	Financial law bill	No				
May 17, 2002	PSOE	Am[c]. 114	Yes	5	Partner and audit team	Listed companies, companies in which the public sector participates, and in general, all companies subject to mandatory audit	ECOFIN recommendations
May 17, 2002	PP	Am.168	Yes	12	(a) Audit firm	(a) Listed companies	To ensure the independence of the auditor
					(b) Partner and audit team	(b) No listed companies under public supervision	
May 17, 2002	CiU	Am. 241	Yes	7	Auditor (if self-employed), audit partner otherwise	Listed companies and companies subject to the supervision and control of the Bank of Spain or to the Financial Services Authority	Recommendations of the EU (Dublin, 2002; ECOFIN, Oviedo, 2002)
May 29, 2002	CiU + PP	Ad. Am[d].	Yes	7	Partner and audit team	Companies under public supervision, listed companies, and companies with turnover higher than 30 million euros	
June 11, 2002	Final report congress		Yes	7	Partner and audit team	Companies under public supervision, listed companies, and companies with turnover higher than 30 million euros	

(*continued*)

Table I.
Auditor rotation 2002: legislative process

Table I.

Date	Political group	Doc[a]	Mandatory rotation	Years[b]	Who rotates?	Which companies are subject to mandatory rotation?	Justification
Senate							
September 17, 2002	PSOE	Am. 179	Yes	5	Partner and audit team	Listed companies, companies where the public sector participates in some proportion, and in general, all companies subject to mandatory audit	ECOFIN recommendations
September 17, 2002	CiU	Am. 207	Yes	7	Partner and audit team	Companies under public supervision, listed companies, and companies with turnover higher than 60 million euros	
October 7, 2002	Final report senate		Yes	7	Partner and audit team	Companies under public supervision, listed companies, and companies with turnover higher than 30 million euros	
Parliament							
November 8, 2002	Final law		Yes	7	Partner and audit team	Companies under public supervision, listed companies, and companies with turnover higher than 30 million euros	

Notes: [a] Document containing the proposal; [b] years: number of years before mandatory rotation; [c] Am.: amendment; [d] Ad. Am.: additional amendment

Even the president of ICAC at that time (López Combarros, a former partner of Arthur Andersen) argued that the temporal limitation of the auditor-client relationship was an interesting proposal but one that necessitated a wide-ranging debate (Arruñada and Paz-Ares, May 19, 1995). The large audit firms were clearly unhappy with the government's proposal, potentially being forced, at some stage in the future, to pass on a significant part of their clientele to other audit firms (*Cinco Días*, May 9, 2002). As the president of KPMG commented:

> . . . with the exception of Italy, there is no compulsory audit firm rotation in any other country, and even there, after ten years using this system, different studies conclude that either groups of professionals leave the audit firm . . . following their clients or audit firms agree to swap their clients. This is a clear signal that rotation is not efficient and it only causes market distortions. On the contrary, rotation of the audit partner and the gradual change of audit teams . . . is something that many audit firms have been doing for years and it works (Mr J. L. Pérez Rodríguez, President of KPMG, *Nueva Economía, El Mundo*, July 14, 2002).

In seeking to understand the government's attitude, it is important to recognize that the *Ley Financiera* (Financial Law) was attempting to increase and reinforce the confidence of investors in Spain, not just due to the international outcry over Enron but also several, unrelated, Spanish financial scandals, the most infamous of which being *Gescartera* (Vico-Martínez, 2002). In some contrast to the immediate aftermath of several corporate failures in the early 1990s (García-Benau *et al.*, 1999), the presence of the Spanish audit firms in the mass media in relation to matters of auditing and audit expectations had, by the end of the 1990s, become relatively limited (*Expansión*, July 28, 2001). The *Gescartera* case, however, had a significant impact on public opinion concerning standards of governance and regulation due to the sheer magnitude of the fraud and its political implications[15].

In response to the government's proposal to reintroduce mandatory audit firm rotation, the opposition parties proposed rotation of audit teams and audit partners. In particular, in the debates in the Congress of Deputies, the senior representative of the socialist party (PSOE), Mrs Costa Campí made explicit reference to *Gescartera* (and Enron) in justifying the need for tighter independence measures, including proposed mandatory audit partner rotation every five years for listed companies, companies in which the public sector participates in any proportion and companies subject to mandatory audit (Congreso de los Diputados, Enmienda 114, May 17, 2002). PSOE's recommendations closely followed the spirit of the ECOFIN recommendations[16] (proposed after the ECOFIN meeting in Oviedo, Spain, April 2002) and the on-going debate in the USA after the Enron scandal:

> We share with other political parties the concerns about the auditor's economic bond with the client, as evidenced in the Gescartera and Enron's cases (. . .). As far as the rotation of audit teams is concerned, our amendment follows the spirit of the recommendations of the ECOFIN (. . .) by establishing mandatory rotation of audit teams every five years. We believe, however, that while it is necessary to support the improvements that this Commission is seeking to put in place, there are two facts that I hope you can allow me to explain. As a result of the events related to Enron, the American House of Representatives is debating a new Act to reform the regulatory framework for auditing (. . .). I invite members of this Parliament to visit the web site of the American House of Representatives and to read the debate of the 18th of March when the rotation rule every four years was discussed. It is important to take this into account because, although the ECOFIN set the rotation requirement, tentatively (as with all its

> agreements), at seven years, this may change in light of the discussions that are currently taking place in the USA Congress (. . .).(Cortes Generales, Diario de Sesiones del Congreso de los Diputados. Comisiones. Año 2002 VII Legislatura Núm. 504. Economía y Hacienda. Sesión núm. 49, Miércoles 29 de mayo 2002, p. 16153).

CiU proposed that auditors should be engaged for an initial three-year period and, then, be available for reappointment for periods of similar duration. For listed and supervised companies, CiU wanted the rotation of audit partners every seven years. CiU argued that this measure would help to reduce the links between auditors and clients, without damaging the quality of audit services and the level of competition in the audit market. Again, this proposal was justified on the basis that it followed the ECOFIN recommendations (Oviedo, April 2002) and the most recent experiences in other European countries (*Congreso de los Diputados*, *Enmienda* 241, May 17, 2002).

The eventual outcome of the parliamentary discussions saw an agreement reached between the government (PP) and CiU over auditor rotation. The government duly tabled an amendment which in the main followed CiU's proposal, with the final draft of the law containing no provisions regarding mandatory audit firm rotation. Instead, it established mandatory rotation of the audit partner and the audit team every seven years, in line with the EU's recommendations[17], for listed companies, supervised companies (such as insurance companies) and for those companies with a turnover higher than €30 million. After three subsequent years, the company could engage again with the same audit partner (Senado, Serie II, num. 86-a, *Texto remitido por el Congreso de los Diputados*, art. 50.4, June 24, 2002).

During the parliamentary debate, CiU did recognise its contacts and negotiations with members of the audit profession (*Congreso de los Diputados, Diario de Sesiones*, 504, p. 16157, May 29, 2002):

> The Grupo Popular[18] had tabled an amendment in which they fixed the duration of the audit contract (. . .). Due to the crucial importance of this amendment for the auditing sector, and after the contacts we have had with the Grupo Popular, with those affected by the amendment [the auditors], and also following the legislation and recommendations of the EU, Convergència I Unió has tabled an amendment which goes into, let's say, a similar direction to that tabled by the Grupo Popular (*Cortes Generales*, *Diario de Sesiones del Congreso de los Diputados*. *Comisiones*. *Año* 2002 VII *Legislatura Núm*. 504. *Economía y Hacienda. Sesión núm*. 49, *Miércoles* 29 *de mayo* 2002, p. 16157).

Although expressing their satisfaction with the proposed legislation and the agreement forged between PP and CiU (*Cinco Días*, May 30, 2002; *El Mundo*, July 14, 2002), once the draft Financial Law was submitted to the Senate, the professional accounting associations (e.g. REA and REGA) showed their disagreement with certain aspects of the draft Law and consequently submitted proposals asking for further changes (REA, 2002; REGA, 2002). In particular, they requested the possibility of renewing the auditor's contract for three years instead of the annual reappointment established in the draft bill. They also wanted to increase the turnover limit over which companies are required to rotate their audit teams and partners (from €30 million to €100 million) (REA, 2002). Different political groups proposed amendments to the draft Law largely following the recommendations described above. CiU again played a very active role in the debate, seeking an increase in the turnover limit (from €30 million to €60 million) and an increase in the length of the reappointment from one year to three years (*Senado*, *Enmiendas* 115, 179, 207, September 17, 2002). None of the amendments

tabled in the Senate, however, were accepted and the draft Law was finally passed in the Congress of Deputies on October 31, 2002 (*Ley 44/2002, de 22 de Noviembre, de Medidas de Reforma de Sistema Financiero*) with the support of PP, CiU and *Coalición Canaria* (nationalist representatives from the Canary Islands)[19]. With the approval of the Financial Law, Article 8.4 of the 1988 Audit Law was modified to include the provision for mandatory rotation of audit partners and audit teams. Some professional bodies, specifically those representing the interest of small and medium audit firms (REA and REGA), nevertheless remained dissatisfied with the new Law due to the implications that the rotation of audit partners would have for small audit firms and self-employed auditors – for a partner practice, audit partner rotation would effectively mean audit firm rotation (*Tiempo*, July 8, 2002; El Mundo, 2002; *Cinco Días*, October 1, 2002; *Expansión*, October 24, 2002). However, as with the political groups in parliament, such professional associations in expressing their concerns made no explicit reference to previous experiences in Spain with mandatory audit firm rotation.

Discussion and conclusions

Narratives, rather than simply offering some chronological listing of facts, can be employed to configure and evaluate events (Parker, 1999, p. 23). This paper has sought to cast more detailed light on the frequently asserted claim these days that "mandatory audit firm rotation did not work in Spain" by reviewing what really has happened in Spain in parliamentary and professional circles since such a requirement was first introduced in 1988. Instead of the traditional view put over by the international accounting profession of an experiment that did not work (ICAEW, 2002; FEE, 2004) the removal of mandatory audit firm rotation emerges as a process that was never given the chance to work. Such a regulatory provision was removed not because of its failed practical impact, but more because it was politically convenient for a government seeking to secure support for other reforms and also because of what it said about the status of the Spanish auditing profession.

The essential puzzle with the Spanish case regarding mandatory audit firm rotation is why there has never been any detailed analysis of its capacity, in the specific context of the Spanish auditing market, to deliver improvements in audit quality. Bougen and Vázquez (1997) once spoke highly of the awareness among Spanish politicians of the practical issues and consequences associated with changing Spanish accounting and auditing regulations – and how the level of political debate seemed much more sophisticated in terms of its understanding of auditing than that reflected in the type of public proclamations made about auditing in the general and business media (for a review of such proclamations, see García-Benau and Humphrey, 1992). The debate on mandatory audit rotation, however, seems a long way from such claimed levels of sophistication. There is also no evidence to support Bougen and Vázquez's (1997) conclusion that Spanish politicians seek to make sure that any company legislation is appropriate for the specific context of Spain and show a marked reluctance to accept blindly the capacity of auditing to deliver particular things (Bougen and Vázquez, 1997, pp. 4-5). Admittedly, the mandatory audit firm rotation was never allowed to operate in practice in Spain. However, collectively, the various debates in the Spanish parliament over the last decade on mandatory audit firm rotation have made no reference to Spanish experience with such a regulatory requirement – neither in terms of how (and why) it was established in Spain in 1988, whether it had ever operated and

why it was removed in 1995. When discussing the development of the 1988 Audit Law, Bougen (1997) noted that in the parliamentary debate opposition parties made little reference to the specific characteristics of the Spanish audit profession and provided no direct Spanish evidence of current audit practice to support their claim of auditing as a profession (Bougen, 1997, p. 768). Instead, they made comparative references to other countries and international experiences (e.g. Japan and USA). A similar behavior was found in our analysis of the parliamentary discussions of issues related to mandatory audit firm rotation: Spanish politicians relied upon EU guidance and the experiences from other countries to support/reject such a policy (without considering their operational capacity in the Spanish context).

Spain has been held up as a case of practical experience ruling out over regulatory dogmatism but in reality practical experience of auditing in Spain has had no obvious influence over the removal or subsequent proposals to reintroduce mandatory audit firm rotation. Classically, when other countries, post-Enron, were holding up Spanish experiences as a reason why not to pursue such a regulatory reform, the Spanish government was responding to Enron by seeking to introduce a 12 year mandatory audit firm rotation period. Similarly, the socialist party (PSOE) when it was in government, both approved and later removed (in 1988 and 1995, respectively) mandatory audit firm rotation without ever demonstrating why it should work or why it was not working. Indeed, it does appear that political support for, or rejection of, particular regulatory options has been rather more opportunistic and rather less based on the logical outcome of a particular form of reasoning – for instance, "this is a reform being supported by the EU, we need to back it."

One possible way of resolving the basis on which regulatory reforms are being implemented or rejected is to view the approach to mandatory auditor rotation in Spain from a broader public policy perspective. Studies of Spanish politics have highlighted that numerous policies passed by Spanish governments never get implemented in practice (Gibbons, 1999). It has been argued that the absence of sufficient political will among those making policy, the technical difficulties unforeseen by those who draft legislation to implement policy and residing policy ambiguities[20] may explain why some government policies do not become operational in Spain (Gibbons, 1999, pp. 130-2). In the case of mandatory audit firm rotation, there are grounds for suggesting that the measure was included in the 1988 Audit Law for "symbolic" rather than "real" implementation[21]. From such a perspective, the PSOE government in the late 1980s could be held to have used the regulation to reinforce the message that the new market for audits would operate with certain restrictions established by the state. As pointed out by Edelman (1960, p. 703):

> ... this is not to suggest that signs or symbols in themselves have any magical force as narcotics. They are, rather, the only means by which groups not in a position to analyse a complex situation rationally may adjust themselves to it, through stereotypization, oversimplification, and reassurance.

For the PSOE government, faced with the task of creating a new, statutory corporate auditing system, the practical complexities of assessing the impact of mandatory audit firm rotation on audit quality and the market for auditing services probably mattered far less than the symbolic message that auditing was an activity that was going to be regulated by the state to a significant degree. This would accord with its refusal to recognize any historical privileges on the part of the existing auditing professional

bodies in Spain and its decision to define auditing as an activity rather than a profession (Bougen, 1997). Moreover, in promoting mandatory audit firm rotation again in 2002, the Spanish government may well have been engaged on a strategic or symbolic push to convince the audit profession that it was well advised to accept the "lesser evil" of mandatory audit partner rotation.

From the auditing profession's perspective it could also be argued that the removal of mandatory audit firm rotation was an equally symbolic issue. Its attempts to establish auditing as a profession rather than a business "activity" (Bougen, 1997) meant securing independence from the state and this was not possible while there was a regulation requiring auditors to resign their tenure no matter how successfully they had provided their professional service. Just as Hopwood (1994) noted how the true and fair override (at the time of the EU's Fourth Company Law Directive) took on symbolic qualities within the UK accounting profession, it could be argued that so too did the repeal of the mandatory audit firm rotation provision in Spain. It was not a case of rotation not working; it was just that claims to professional status could not sit side-by-side with such a legislative provision.

The rotation policy issue, however, returned to prominence at the beginning of the 2000s: the international pressures to reinforce auditors' independence after some well-known audit failures along with internal pressures derived from some financial scandals in Spain led to Spanish authorities reviewing the national framework for auditor independence. Professional bodies managed to avoid the implementation of mandatory audit firm rotation – one of the alternatives proposed by the government. They were unable, however, to "prevent" the government from doing something – namely approving the requirement of audit partner and audit team rotation, following the recommendations of the EU.

The literature on Spanish politics also suggests that we are unlikely ever to get definitive answers and closure on the case of mandatory audit firm rotation. For instance, it has been said that the (public) articulation of the claims of interest groups on a permanent and continuous basis in Spain has been hindered by a lack of institutional stability (Linz, 1981; Molins and Casademunt, 1998) – although this does not mean that particular social and economic interest groups do not exercise a decisive (private) influence on the policy-making process (Linz, 1981, p. 367). As Molins and Casademunt (1998, p. 124) argued:

> ... the interplay of personal relations and interests between political and economic powers has decisively conditioned the manner in which interest groups in diverse social sectors have become established and has forged a style of mediation in which having the right personal contact is prized and rewarded.

As a political grouping, CiU clearly played a significant role in all discussions about the mandatory rotation of audit firms in Spain – with its position, as that of other relatively small political groups such as *Partido Nacionalista Vasco* (PNV – Basque Nationalist Party), being favored by the way the Spanish elections in 1993 and 1996 led to periods of minority government. CiU was the only political party in parliamentary debates on auditing to highlight its links with the profession. However, the "behind the scenes" discussions and contacts between CiU, the government and the auditing profession have not been made (and given the above political traditions in Spain, are unlikely to be made) public.

In the 1990s, the auditing profession in Spain exhibited clear tendencies of acting like a special interest group or a trade association. The evidence is suggestive of a prevalence of the private interest over the public interest, comparable to what has been documented in previous research on the behavior of the accounting and auditing profession in Anglo-American settings (Parker, 1994; Canning and O'Dwyer, 2001). Moreover, claims that international accounting firms have considerable influence over regulatory processes both nationally and internationally (Cooper and Robson, 2006, p. 433; Mügge, 2006) is applicable to the Spanish environment, where Big firms representatives have increasingly come to dominate in terms of the formulation of audit policy and the public representation of such policies (Ruiz-Barbadillo *et al.*, 2000, p. 138 for a discussion of the issue of auditors' liability in Spain; Serrano, 2002). One of the consequences of having the Big firms "shaping" professional agendas is that auditing in Spain (as in other jurisdictions – for example, see Sikka and Willmott, 1995; Fogarty *et al.*, 1997; Humphrey *et al.*, 2004) is seen to be of a lesser status – in terms of job satisfaction and career development) relative to activities such as management consulting (Cañibano and Castrillo, 1999; Martínez-García *et al.*, 2000; *Expansión*, 3 March 2005; Pérez-López and López-Gavira, 2005).

In many respects what has happened with respect to mandatory audit firm rotation is not that surprising. Through a range of papers (García-Benau *et al.*, 1999; Ruiz-Barbadillo *et al.*, 2000; Vico-Martínez, 2002), Spain has now been highlighted as having over-optimistic public expectations of auditing, a profession that has talked up a liability crisis and sought to challenge, if not undermine, the work of its independent audit regulatory body – together with major audit firms who, across a string of corporate scandals, have been shown to be operating in some questionable ways and circumstances. Given a constellation of professional bodies and firms principally out to protect and promote their self-interests, a government increasingly under pressure to conform to the norms of the international regulatory arena, a relatively dispassionate investing public and minority political parties keen to make political deals, mandatory audit firm rotation may well have been destined to be removed in a fairly quiet fashion.

The worry academically is that Spanish auditing research is struggling to get to the heart of what life is really like in professional auditing and regulatory circles. Much of this research still remains at a rule-based level (considering what auditing standards should be like and how responsibility of auditors is defined - for typical examples, Pacheco, 2000; Sánchez Fernández de Valderrama, 2006) or is focused on comparing the formal elements and components of different national auditing and accounting systems (Bello-Peribañez, 1997; Gonzalo-Angulo, 2002; Rodríguez-Hernández, 2003; De la Peña-Gutiérrez, 2004; Mir, 2006). At a time, internationally, when there is so much current concern with issues of harmonization and the development of global auditing and accounting standards, such a research concentration may be understandable but it is not sufficient. This paper, by analyzing the regulatory process about mandatory audit firm rotation in Spain, has attempted to get "inside" Spanish auditing and regulatory circles. However, there is still a need to get answers to a vast array of questions as to whether and how the internationalization of auditing systems has changed Spanish auditing firms, audit practices and regulatory approaches (Ruiz-Barbadillo *et al.*, 2000). With Spanish academics under pressure to publish internationally, but with a perceived bias against Spanish empirical case studies[22], there has to be some doubt as to how much progress is going to be made in this area

– particularly, if research access continues to be so difficult to secure in Spanish organizations. This would be a shame as there remain numerous issues of interest and international relevance to pursue in a contemporary Spanish auditing context.

As this paper has shown, there are significant political dimensions associated these days with audit research. Just through the single regulatory issue of mandatory audit firm rotation, Spain changed from a country that seldom attracted the attention of the international professional accounting community to one that was quite central to critical international post-Enron regulatory debates. At another level, (specially commissioned) research was used to provide "valuable" empirical evidence on experiences with mandatory audit firm rotation, yet such "confidential" research studies not only proved difficult to access but also seemed to be of questionable empirical strength. One clear implication of this paper is the importance of being able to draw on academic commentaries of audit regulatory processes that have not been compromised by having their work agendas dictated to or manipulated by the professional accounting firms and bodies (Mitchell *et al.*, 2001). Regulatory reform is too significant an issue to be left to the sole remit of the auditing profession and/or "commissioned" audit researchers and market research agencies.

This paper provides evidence on the way in which Spanish experience has been used (or misused) by professional associations and auditing firms in formulating as a foundation for their position regarding the policy of mandatory audit firm rotation. In so doing, it also lends support to those who have questioned the level of transparency and accountability in regulatory arenas and the extent to which the big four firms are now dictating policy processes (Sikka and Willmott, 1995; Cooper *et al.*, 1998; Gendron and Bédard, 2001; Caramanis, 2002; Cooper and Robson, 2006; Mügge, 2006). Claims emanating from professional accounting circles need to be treated carefully and in-depth, independent research can play a significant role in today's international audit policy arena – in particular, clarifying some of the "taken for granted" arguments which are part of the rhetoric of professional bodies and international audit firms. The benefit of careful, detailed historical research in the area of auditor rotation has already been demonstrated by Zeff's (2003) analysis of the Du Pont Company. With Spanish experiences with a policy of mandatory audit firm rotation having rapidly assumed international significance, it is hoped that the detailed analysis presented here has at least helped to set the historical record straight.

To sum up, our contribution to the existing international auditing literature is centered on emphasizing the importance of making sure that explanations and empirical justifications as to what works or does not work in terms of regulatory reform are accurate and not built on myth and misunderstanding. In pursuing this agenda, the paper demonstrates the value of academic research and the importance of a historical perspective when studying regulatory reform. It also shows how important national experiences and histories can get lost or misrepresented in today's increasingly globalized world, while the nature and pattern of interactions between the global and the local remain capable of being rather less predictable than the much heralded era of harmonization and standardization tends to imply.

Notes

1. Neither the Bocconi study nor that by Arruñada and Paz-Ares have been published and, accordingly, have not been subjected to academic peer review. Gaining access to both studies

was not an easy process (for a similar reported experience, see Moizer, 2003), not least because the Bocconi study was initially classified as a "confidential document" having been prepared directly for the European Contact Group, which represents the six largest accounting networks in the EU (BDO, 2003). However, we eventually managed to access the Bocconi study, an additional paper by the authors of the Bocconi study reporting the results of the survey and the original version of the Arruñada and Paz-Ares paper.

2. The date of the removal is 1995, not 1997 as stated in the paper (Ng, 2003, p. 2).
3. According to the annual reports of ICJCE, in 1973 members of the ICJCE performed 354 audits. This figure increased in the 1970s, reaching a high of 698 audits in 1976, but declining subsequently to 384 audits in 1985, only slightly higher than the corresponding figure in 1973.
4. In Spain, as in many other countries (e.g. the UK and USA), auditors are appointed by the shareholders at the Annual General Meeting (Junta General de Accionistas) (Art. 204.1 Texto Refundido de la Ley de Sociedades Anónimas; 1989 Limited Companies Act).
5. The 1988 Audit Law was applicable from the first financial year after the approval of the law in July 1988 (1988 Audit Law, Disposición Final Quinta). The 1989 Limited Companies Act, was applicable from January 1, 1990. Following these requirements, companies had their first audits in 1990 (year-end financial statements after July 1988 and 1989) and 1991.
6. Data indicates that in 1993 there were more than twice the number of auditors' changes in 1992 and 1994 (for listed companies, in 1993, 35 companies changed auditors (8.8 percent), compared to 16 (3.8 percent) in 1992 and 15 (4.3 percent) in 1994).
7. The 1988 Audit Law required mandatory audits for listed companies and supervised companies (such as insurance and financial services companies) while the Limited Companies Act required audited financial statements for companies with either assets above €5.5 million (Pts 920 million.), turnover above €11.5 million (Pts 1.9 billion) or more than 250 employees. By 1991 the number of audits registered at ICAC stood at 16,492 mandatory and 4,059 voluntary audits – an enormous difference to the pre-1988 legislative days when companies being audited (according to ICJCE data) were substantially less (384 audits, all of them voluntary audits).
8. For example, between 1992 and 1996, 38 sanctions were imposed by ICAC, of which 47 percent (18) were economic sanctions, with 32 percent (12) taking the form of a "public warning" to the auditor/audit firm and the remaining 21 percent requiring the removal of the auditor/audit firm from the list of registered auditors for a specified period of time (Navarro-Gomollón and Bernad-Morcate, 2004, p. 13; for more discussion, see Gonzalo-Angulo and Gallizo, 1992; García-Benau and Humphrey, 1992; García-Benau *et al.*, 1999).
9. Spain has a bi-cameral parliament consisting of two chambers: the Congress of Deputies (Congreso) and the Senate (Senado). Draft parliamentary bills (anteproyectos de ley) are initially prepared in governmental ministries and approved and amended, if necessary, by the Cabinet. Once they become proper parliamentary bills (proyectos de ley) and published in the Official Journal of the Congress (Boletín Oficial de las Cortes), they are available for public scrutiny. After a bill is published a time frame of fifteen days is opened in which parliamentary groups can present amendments, to either the whole text or partial amendments to certain sections. The first debate in the Plenary Sitting takes place once the time limit for presentation of amendments has passed. The debate usually begins with the introduction of the text by a member of the Government. Then a report is made, based on the text, by a Member of the Committee working on the bill. Once the presentation has finished, the debate is governed according to the dispositions of the Speaker, heard by the Mesa del Congreso and the Junta de Portavoces (Bureau and the Board of Spokesmen). Thanks to the application of a special procedure, known as the full legislative authority of

the Committee, the bill can go directly to the Senate after its approval by the Committee. In the Senate, a similar pattern prevails, although within a more restricted period of time. After a spell in the Senate, bills are brought back to the Congress where they are presented for final approval or rejection, including any amendments proposed by the Senate (Gibbons, 1999, p. 104; www.congreso.es – accessed February 10, 2005).

10. According to CiU's proposal, such reappointments should follow the same requirements as initial engagements: contracts for a minimum of three and a maximum of nine years.
11. A senior official at ICAC, when interviewed, confirmed that this was Bolufer's personal position and that ICAC had not declared an official view on this matter.
12. PSOE's political weakness at the time the rotation rule was removed was also mentioned by the senior official of ICAC interviewed by the authors.
13. In 1996, after 14 years in government, the Socialist Party (PSOE) lost the general elections. The conservative party (PP) led by José María Aznar, was unable to capture sufficient votes to command an overall majority in the Spanish parliament so they needed the support of Catalan and Basque nationalists groups (Convergència i Unió (CiU) and Partido Nacionalista Vasco (PNV)) to form a government. In the general elections of 2000, PP won the elections again but this time with sufficient votes to have an overall majority in the Spanish parliament.
14. The Preamble of Ley Financiera established that its three main objectives were: to guarantee that the legal system does not impose unnecessary constraints on Spanish financial institutions which would put them at a certain disadvantage in comparison to their European counterparts; to improve the protection of users of financial services given the higher level of competitiveness in the market and the use of new technologies; and to help to channel savings into the real economy by improving the mechanisms available for small- and medium-size enterprises (SMEs) to obtain financial resources.
15. Gescartera was a brokerage firm that invested in the stock market and became involved in the Spain's worst stock-market fraud leaving €87 million of funds unaccounted for. It provoked high profile resignations including those of the chairwoman of the national stock market watchdog (Comisión Nacional del Mercado de Valores) and a junior finance minister whose sister helped run the brokerage house. The fact that Deloitte & Touche had given Gescartera clean audit reports in its most recent sets of annual financial statements certainly helped to put auditing and the audit profession back in the public spotlight.
16. Spain had taken over the rotating presidency of the EU in January 2002, meaning that, at the time of the ECOFIN meeting in Oviedo (Spain), Spain was effectively leading the EU. While the opposition parties such as PSOE and CiU followed the ECOFIN recommendations, this was not the case for the Spanish governing party, PP. It would also appear that PP's proposals for mandatory audit firm rotation were not that influential, if discussed at all, at the ECOFIN meeting.
17. The EU recommendations include audit partner rotation in the following terms: "as a minimum to replace the Key Audit Partners of the Engagement Team (including the Engagement Partner) within seven years of appointment to the Engagement Team. The replaced Key Audit Partners should not be allowed to return to the Audit Client engagement until at least a two year period has elapsed since the date of their replacement" (EU, 2002).
18. In the Congress and Senate political parties are categorised by parliamentary groups. The Partido Popular (PP) forms the "Grupo Popular" (Popular Group); the Socialist Party (PSOE) is called the "Grupo Socialista" (Socialist Group). CiU on its part belongs to the "Grupo Catalán" (Catalonian group).
19. PP and CiU co-operated not only in relation to regulations on auditor rotation, but also in terms of a number of other rules and measures included in the Financial Law. This Law,

which was the most important reform of financial regulation in Spain in recent years, modified around twenty financial existing rules, the most controversial ones being those relating to the regulation of saving banks (Cajas de Ahorros). Although a description of the main changes derived from the approval of the Financial Law goes beyond the purpose of this paper, it is worth noting that PP and CiU also worked together on regulations relating to saving banks and measures and mechanisms to promote the development of SMEs – an issue that was common to the agenda of both political parties since early 2001 (Expansióndirecto, March 12, 2001).

20. For instance, the 1985 Spanish Tax Act enabled savers a form of legal tax evasion as a consequence of some weaknesses in the law (Gibbons, 1999, pp. 130-1).

21. A sentiment that was confirmed in interview by a senior official at ICAC.

22. To the extent that Spanish cases are either not researched, referred to as "intriguing" or "unusual" cases to justify their presence, or have all Spanish traces (including Spanish references) removed from them in attempt to bolster the chances of convincing international referees that the paper makes a significant contribution to knowledge – for more discussion, see García-Benau and Laínez-Gadea (2004).

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