



## **Audit Selection in the European Football Industry under Union of European Football Associations Financial Fair Play**

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### **ABSTRACT**

The scope of this study is to examine the characteristics of football clubs that choose a high quality auditor and whether this audit selection process was different before and after the implementation of Union of European Football Associations (UEFA's) financial fair play regulation. The study employs a sample of 109 European football clubs for a 7-year period, 2008-2014 (3 years before and 4 years after regulatory intervention), to investigate the impact of this regulatory intervention upon the decision of clubs to hire a big-4 audit firm. The study demonstrates that after FFP implementation, profitability and cash flows became highly significant factors urging clubs to select a big-4 audit firm in order to signal to the market and the regulators that they are able to achieve the regulatory requirements. UEFA should take into consideration that, the imposition of regulatory monitoring tied to accounting data may lead to adverse behavior on behalf of the clubs, thus reducing the effectiveness of the new regulation.

**Keywords:** Audit Quality, Audit Selection, European Football Clubs, Financial Fair Play

**JEL Classifications:** M41, M42

### **1. INTRODUCTION**

Over the years the European football industry has transformed from an emotional and amateur activity into a multimillion business attracting the interest of investors, media, sponsors and supporters throughout the world (Kennedy, 2013; Storm and Nielsen, 2012). The professionalization of sport has created an environment where special attention is given to the management of sport organizations (Hoye, 2006). Managers need to have special skills and knowledge, guidance, and coordination abilities in order to lead the organization to success (Zec, 2011). The administration of professional football clubs requires strategic planning, management of human resources and effective financial management (Hoye, 2006).

However, the financial condition of the majority of football clubs in Europe indicates that they are exercising a rather inefficient management of resources since on the one hand they achieve a consistently impressive revenue performance (Morrow, 2014), but on the contrary clubs have consistently failed to transform revenues into sustainable profits, which sets their financial sustainability in jeopardy (Deloitte, 2014; Kennedy, 2013; Storm

and Nielsen, 2012). As Barros (2006), de Barros et al. (2007), Dimitropoulos (2011) and Emery and Weed (2006) argue, the constant inability of clubs to implement sustainable management and governance policies led to growing debts and accumulated losses (Deloitte, 2015; 2014; Gammelsæter, 2010; Robinson and Simmons, 2014; Storm and Nielsen, 2012).

In an effort to rationalize club finances and enhance management rationality and transparency, Union of European Football Associations (UEFA) issued the financial fair play regulation (FFPR) in 2010. The scope of UEFA is to monitor the clubs' financial position and performance on the basis of the financial information reported, requiring clubs to "balance revenues and expenses" or "break even" (Morrow, 2013; 2014; UEFA, 2010), avoid reporting negative equity changes, set overdue payables and finally to prove their going concern ability. The inability to meet the economic thresholds set by the FFPR would automatically lead to sanctions and a loss of revenue which would put the financial viability of most clubs at risk.

Under the FFPR the club's external auditor has a significant role on the assessment of financial reports integrity and accuracy.

## 2. LITERATURE REVIEW

Being more significant, the auditor beyond verifying the going concern ability of the club he/she reviews the interim and annual financial reports and submits to the licensor all information (basic and supplementary if required) in order to form the basis for the licensing decision. In other words, auditor's report becomes crucial for clubs' licensing. Under this framework FFP dictates that if the auditor report has an adverse opinion or an emphasis of matter or a qualified "except for" opinion regarding the club's going concern ability, the licensor can refuse to grant the license to the club. Finally, if auditor's opinion in a matter other than the going concern gives an emphasis of matter or an "except for" opinion, the licensor must request additional information for granting the license. Otherwise, if this information is not submitted the club will be not granted the license.

Based on the above discussion is clear that the selection of the external auditor by the club's management team is a strategic decision since the quality of the audit process can have a significant impact on the outcome (financial reports) and the ability of the club to receive the license. Big-4 audit corporations are considered by many researchers as high quality auditors (Hsu et al., 2015). According to Knechel et al. (2007) auditors influence accounting quality since their role is to restrict incidents of financial misstatement and managerial discretion (Dechow et al., 2010) and their capacity to do so is closely related to their independence, expertise and litigation risk. Generally, big-4 audit corporations have more resources and expertise in order to provide high quality audits and also are less willing to sacrifice their reputation in order to accommodate client's demands (Woo and Koh, 2001; De Angelo, 1981). Under this framework, the scope of this study is to shed more light on the characteristics of clubs that choose high quality auditors (big-4 audit firms) and whether this behavior changed after the implementation of FFPR.

The contribution of the present study to the relevant literature of audit selection is that it illuminates an important feature of the management practices of the European football industry in the aftermath of an important regulatory intervention that has not been considered by previous studies. It demonstrates that, managers altered their decision on hiring a high quality auditor based on club's profitability and cash flow generating ability. In other words, after FFP implementation clubs with low profitability and cash flows intensively seek to project an image of financial robustness in order to secure much-needed funding by hiring a high quality (big-4) audit corporation. The results also provide insights for UEFA regulators and audit firms by demonstrating that implementing regulation based on strict financial criteria as UEFA's FFP rules, leads to changes on football clubs' management behavior since managers can choose to affect audit quality in order to achieve the FFP prerequisites and secure much needed funding.

The rest of the paper is organized as follows: The next section discusses the literature on audit quality and audit selection. Section three describes the data and research methods followed. The fourth section presents the empirical results and the sensitivity analysis. Finally, the fifth section concludes and provides policy implications and suggestions for future research.

According to De Angelo (1981), audit quality is defined as the joint probability that a given auditor can discover an irregularity in the client's accounting system, and he/she will report the alleged violation. The probability that the auditor will report the identified inaccuracies is defined by De Angelo (1981) as auditor independence. Therefore, audit quality is the increasing function of the ability of an auditor to detect and report accounting inaccuracies (Lin and Liu, 2009). Moreover, Watts and Zimmerman (1986) define the audit quality as the probability of an auditor to discover and present infringement reports to the company's accounting system. Thus audit quality is a function of two properties of the auditors, knowledge and independence. Mednick (1997) adds that auditor independence is the cornerstone of the accounting profession and the probability of false reporting depends on the integrity (Johnson and Lys, 1990) and honesty (Watts and Zimmerman, 1986) of the auditor and high audit quality sends a message to the market that the financial statements are reliable and transparent. This has empirically been verified by Leventis and Dimitropoulos (2010) in the Greek capital market and specifically audit independence is positively associated to the quality of the audit outcome.

The selection of firm's auditor is based on the requirement for quality control. Beattie and Fearnley (1995) reported that dissatisfaction with audit quality is one of the most common reasons cited for selecting different auditors. A company may choose higher quality auditors in order to provide more reliable information to investors and creditors (Leventis and Dimitropoulos, 2010). Also, the degree of client complexity and risk significantly affect the production of statutory audits regarding (a) the extent or duration of the audit and (b) the personnel responsible for the audit (Caramanis and Lennox, 2008). For example, in case of highly risk customers high audit quality is secured by the hiring of auditors with more experience (Johnstone and Bédard, 2001) and specialization on the specific industry (Johnstone and Bédard, 2003). Apart from the risk of the customer, audit quality is also affected by the corporate governance (Johnstone and Bédard, 2004; Lin and Liu, 2009) of the organization, its ownership structure (He et al., 2014), the disclosure policies (Krishnan and Sengupta, 2011) and the political risk of the audit firm (Redmayne et al., 2010).

Furthermore, firm's financial characteristics are proved significant indicators of selecting (or not) high quality auditors. Hudaib and Cooke (2005) demonstrate that distressed firms are more likely to replace their auditors or select low quality auditors with a view to securing favorable audit reports. Members of the big-4 are less likely to compromise over audit procedures and outcomes (DeFond and Subramanyam, 1998; Palmrose, 1988) and are also more likely to avoid excessive risk in audit engagements (Brandon et al., 2012). Additionally, Hsu et al. (2015) argue that firms that are at risk to fail on achieving the criteria of financial regulations are prone to hire a non-big-4 (low quality) auditor in order to mask their position and achieve the required thresholds. In the case of the football industry, it is expected that the implementation of FFPR (2011-2014), will lead clubs to change their decision

regarding audit selection since their financial condition puts even more pressure on management to achieve the required criteria set by the FFPR.

### 3. DATA AND METHODOLOGY

#### 3.1. Data Selection Procedure

The first step on the sample selection process was to focus on firms organizing activities of sports clubs having the legal form of a corporation. Secondly, 15 European countries were selected for the study (namely Belgium, Croatia, Czech Republic, Denmark, Finland, France, Germany, Greece, Italy, Netherlands, Norway, Poland, Spain, Ukraine and United Kingdom) which had at least two football clubs available with at least 2 years of annual financial data for the period 2008-2014. The initial sample included 117 football clubs but due to data limitations 6 clubs were removed and further trimmed the upper and lower 1% of the data distribution in order to reduce the impact of outliers and thus any biases in the estimation of the main model, thus ending with a final balanced sample size of 109 football clubs.

The sample is restricted to football clubs that participate in the elite division of each country's official championship for reasons related to data availability and reliability and mainly because clubs competing in the top division are the only contestants for participating in UEFA championships and thus they undergo intense scrutiny by local and European regulators. Sample clubs are those having participated in the UEFA competitions (finishing in the top positions in the each league) since those clubs are motivated to achieve the targets of FFPR.

The sample is divided into two sub-periods: The pre-FFPR period (including fiscal years ending in June 2008, 2009 and 2010) and the post-FFPR period (fiscal years ending in June 2011, 2012, 2013 and 2014). The reason for this definition is the fact that the 2010–11 football season (and fiscal year) is the first during which the FFPR was in force and therefore captures the reporting results on either side of this point of reference. The implementation of FFP was not in full force in the fiscal year ending in June 2011, rather it was introduced with some acceptable level of deviation from the regulation's financial target, however, it may still constitute significant motivation for selecting or not high quality auditors. All data were hand collected from clubs annual financial reports and other public available information.

#### 3.2. Research Design

In order to examine the determinants of audit selection we followed previous studies on the field (He et al., 2014; Lin and Liu, 2009; Hsu et al., 2015) and use a panel logistic regression with a dichotomous variable BIG4 as the dependent variable which receives unity (1) if the club is audited by a big-4 audit corporation (KPMG, Deloitte, PwC, Ernst and Young) and zero (0) otherwise. The panel data method is selected due to the fact that it can capture the time-series and cross sectional effects of the data and provide more accurate inferences on the impact of various corporate characteristics and the FFP implementation on the audit selection variable. So the main model receives the following functional form:

$$BIG4_{it} = a_0 + a_1 FFP_t + a_2 CONTROLS_{it} + a_3 FFP_t * CONTROLS_{it} + e_{it} \quad (1)$$

FFP is a dummy variable receiving unity (1) for the post-FFP implementation period (fiscal years ending in June 2011, 2012, 2013 and 2014) and zero (0) for the pre-FFP period (2008, 2009 and 2010). CONTROLS is a vector of control variables (company characteristics) which impact on audit selection. The FFP\*CONTROLS is the vector of control variables multiplied with the FFP dichotomous variable and capturing the impact of FFP implementation on the determinants of audit selection. Consequently, if FFP impacted on the decision of football clubs to hire high quality auditors we expect to find an inverse sign on the coefficients between pre- and post-FFP implementation.

The first control variable is foreign ownership (FOWN) which is a dummy receiving (1) if a club has a foreign owner in a given fiscal year and (0) otherwise. According to Wilson et al. (2013), foreign ownership has been a distinctive characteristic of the football industry in Europe. According to He et al. (2014), foreign investors have greater motives to affect the quality of audit because they face more informational disadvantages relative to local investors. This fact motivates them to employ high quality auditors as a safeguard against this information asymmetry. Thus, a positive coefficient is expected on that variable.

Furthermore, another control variable is the listing status of football clubs (DLIST). Burgstahler et al. (2006) argue that, in contrast to unlisted firms, public companies operate under stricter institutional monitoring and legislative frameworks. Therefore, institutional monitoring provides incentives to make earnings more informative or, alternatively, to produce financial information of high quality in order to be listed in the stock market. Hence, the intense institutional monitoring exercised on listed firms motivate them to hire a high quality auditor (big-4), therefore, a positive coefficient is expected on this variable. Football clubs' size (SIZE) is the third control, measured as the natural logarithm of total assets (Dimitropoulos, 2011). Lin and Liu (2009) point that larger companies tend to hire high quality auditors, so it is expected a positive relation between the size of football clubs and the tendency to hire big-4 auditors. Additionally, leverage (LEV) is measured by the ratio of total liabilities to total assets. Prior literature suggests that highly-leveraged firms have greater incentives to hire big-4 auditors in order to mitigate the suspicion of the market on their performance and financial results (Lin and Liu, 2009; Reed et al., 2000). So a positive coefficient is anticipated for LEV.

Two additional control variables are GROWTH (GR) and profitability return on assets (ROA), measured as the percentage change of the company's sales from year  $t-1$  to  $t$  and the ratio of net income to total assets respectively. According to Anderson et al. (2004), Lin and Liu (2009) and He et al. (2014) high growth and profitable firms are tending to hire high quality auditors in order to signal a good reputation to third parties though. Thus, is expected that high-growth and profitable football to select big-4 audit firms, leading to positive GR and ROA coefficients. The last control variable is the ratio of operating cash flows deflated

by lagged total assets CFO. According to Dimitropoulos (2011), clubs with increased cash flow streams tend to reinvest funds in the business without resorting to external funds. This causes them to be less prone to hire high quality auditors in order to signal a good reputation to the market. Thus, the cash flow variable is expected to have a negative coefficient. All variable definitions are provided in the Appendix.

#### 4. EMPIRICAL RESULTS

Table 1 presents the descriptive statistics of the sample variables for the period 2008-2014 as clustered between pre- and post-FFP periods. At first, sample clubs seem to be in a slight better financial condition during the post-FFP period, since ROA is less negative (clubs generated less losses) and the difference from the pre-FFP period is statistically significant at the five per cent level. Practically, this indicates that sample clubs continue to be in dire financial straits even during the implementation period of the FFP since they continue to report losses. It is also evident that a significant number of clubs hired big-4 auditors during the post-FFP period but the difference relative to the pre-FFP period is not statistically significant. Moreover, the sample football clubs increased their leverage significantly during the post-FFP period but the number of clubs that were listed on the stock exchange remained relatively unchanged. Furthermore, 10% of the sample clubs are controlled by foreign investors, a percentage which remained stable during the post-FFP period.

Table 2 presents the empirical findings from the estimation of equation 1. The association between the dependent variable and the independent variables is statistically significant (LR  $\chi^2 = 165.31$ ;  $P < 0.001$ ). The results indicate that the implementation of the FFP regulation changed the behavior of football clubs towards hiring high quality auditors. More specifically, leverage has a positive coefficient during the pre-FFP period indicating that highly leveraged clubs tend to choose big-4 audit firms. This result verifies arguments in the literature that highly leveraged firms hire high quality auditors in order to send a sign of reliability to the market (Lin and Liu, 2009). However, after FFP implementation the relative coefficient has a negative and significant sign indicating that highly leveraged clubs prefer low quality auditors in order to mask their financial condition from the market and regulators (Dimitropoulos, 2011). The same interpretation can be made for the coefficients on ROA. Before the FFP regulation highly profitable clubs were audited by the big-4 audit firms. After FFP inauguration the less profitable clubs tend to hire high quality auditors. Again the interpretation of this outcome is attributed to the need of less profitable clubs to achieve the required criteria of the FFP regulation and the hiring of a high quality auditor can assist them towards this goal. The aforementioned results are further corroborated by the coefficients on the CFO variable which follows the same pattern as the LEV and ROA. Regarding the rest of the control variables, SIZE has a positive and significant coefficient for the pre-FFP period indicating that big clubs tend to hire high quality auditors and the same stands for clubs owned by foreign investors. These results verify findings by Lin and Liu (2009) and He et al. (2014) that foreign investors have greater motives

**Table 1: Descriptive statistics of the sample variables pre- and post-FFPR**

Variables	Mean±SD		Mean diff.	Sig.
	PRE-FFPR	POST-FFPR		
ROA	-0.100±0.243	-0.073±0.234	-0.026	-1.74*
SIZE	9.698±2.300	9.901±2.296	-0.203	-1.146
LEV	1.042±0.861	1.071±0.974	-0.028	-1.702*
GROWTH	-0.047±0.692	-0.007±0.085	-0.040	-1.132
DLIST	0.040±0.197	0.036±0.186	0.004	0.292
CFO	0.095±0.515	0.116±0.421	-0.020	-0.576
FOWND	0.101±0.301	0.100±0.301	0.001	0.021
BIG4	0.195±0.397	0.226±0.419	-0.031	-0.997

\*Indicate significance at the 5% significance level. Mean difference indicates the mean change of variables between the pre-FFPR and post-FFPR periods. T-statistics are estimated for continuous variables and Wilcoxon-Mann-Whitney Z-statistics for categorical variables. FFPR: Financial fair play regulation, ROA: Return on assets, SD: Standard deviation

**Table 2: Pane logit regression results on audit selection and FFPR**

[Big-4]	Coefficient	P
Constant	-6.834**	0.000
FFP	0.517	0.741
DLIST	1.056	0.105
FFP*DLIST	0.005	0.995
FOWND	1.248*	0.011
FFP*FOWND	0.112	0.862
SIZE	0.461**	0.000
FFP*SIZE	-0.024	0.854
LEV	1.066**	0.000
FFP*LEV	-0.757*	0.015
CFO	4.688**	0.004
FFP*CFO	-4.278*	0.014
GROWTH	0.084	0.828
FFP*GROWTH	0.163	0.916
ROA	6.718**	0.003
FFP*ROA	-6.211*	0.013
LR $\chi^2$		Country dummies
165.31		included
(0.000)**		

\*,\*\*Indicate statistical significance at the 5% and 1% level respectively (P-value with two-tailed test). FFP: Financial fair play, ROA: Return on assets

to affect the quality of audit because they face more informational disadvantages relative to local investors.

In order to examine the robustness of the findings, several sensitivity tests were performed regarding model specification and variable definition. Firstly, following He et al. (2014) Model 1 was re-estimated using the annual change in the control variables instead of levels. The results remain qualitatively unchanged as those on Table 2. Also, alternative proxies were applied on the estimation of the control variables. As in Lin and Liu (2009), size was measured by the natural logarithm of revenues, return on equity replaced ROA as the profitability variable and leverage was estimated as the ratio of long-term debt to total equity. The results were robust to the different definitions of control variables. Finally, Model 1 was re-estimated after deleting observations within all variables that were more than 3 standard deviations away from the means without affecting the final results. Thus, the main findings on Table 2 are robust in explaining the determinants of audit selection within the European football clubs.

## 5. CONCLUSIONS

European football clubs operate under dire financial straits and present problems of financial instability mainly attributed to the strong relationships with supporters which undermine the importance of financial rationality. UEFA in an attempt to discipline football club management introduced the FFP regulation which sets specific criteria for club licensing, mainly on monitoring clubs' financial activity based on the accounting data produced. FFP determines that external auditors have a significant role on the assessment of financial reports integrity and accuracy. Therefore, the determinants of audit selection by European football clubs is an important issue warranting further examination since it affects the quality of the audit and the reliability of financial results which form the basis for the licensing decision.

Under this framework, the present study examined whether the implementation of UEFA FFP regulation impacted on the audit selection determinants within the European football industry. Based on a sample of 109 football clubs, evidence suggested that in the aftermath of the establishment of the FFP regulation, highly leveraged clubs prefer low quality auditors in order to mask their financial condition from the market and regulators (Dimitropoulos, 2011). Also after FFP introduction the less profitable clubs tend to hire high quality auditors. Again the interpretation of this outcome is attributed to the need of less profitable clubs to achieve the required criteria of the FFP regulation and the hiring of a high quality auditor can assist them towards this goal. Moreover, larger football clubs and with foreign ownership tend to hire high quality auditors.

The present study contributes to the current literature in two respects. Firstly, it sheds light upon important determinants of European club audit selection in the aftermath of the establishment of FFP regulation. Managers altered their decision on hiring a high quality auditor based on club's profitability, leverage and cash flow generating ability. In other words, after FFP implementation clubs with low profitability and cash flows intensively seek to project an image of financial robustness in order to secure much-needed funding by hiring a high quality (big-4) audit corporation.

The implications of the findings are important for regulators and stakeholders. UEFA should take into consideration that implementing regulation based on specific financial criteria leads to changes on football clubs' management behavior, since managers can choose to affect audit quality in order to achieve the FFP prerequisites and secure much needed funding. Thus, the outcomes of this regulatory effort may diverge from regulators' intended purposes and may, in turn, reduce rather than improve club management transparency and credibility. The findings of this study provide several avenues for future research. One possible direction is to examine the selection of external auditors in conjunction with audit fees paid by the football clubs pre- and post-FFP implementation. Also it will be interesting to examine how corporate governance and other managerial features of football clubs impact on the audit selection process.

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## APPENDIX

### Variable definitions

BIG4=1 if the club has hired a big-4 auditor during the implementation of FFPR, 0 otherwise  
 ROA=Return on assets estimated as the ratio of net income to total assets  
 CFO=Annual operating cash flow divided by lagged total assets  
 SIZE=Natural logarithm of end of year total assets  
 GROWTH=Percentage change in operating revenue  
 LEV=Ratio of end of year total liabilities to end of year total assets  
 DLIST=1 if a club is listed on the stock market, 0 otherwise  
 FFP=1 for fiscal years 2011, 2012, 2013 and 2014, 0 otherwise  
 FOWND=1 if the majority shareholder is foreign, 0 otherwise

FFP: Financial fair play, ROA: Return on assets