

Practice Note:
Economic Consequences of Joint audits

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Economic Consequences of Joint audits

What are joint audits?

In a joint audits system, two auditors are hired by a company to provide an audit report and an opinion. Currently, France is the only European country with mandatory joint audits. The French Code de Commerce (art. 823-2) stipulates that “*people and entities required to publish consolidated accounts appoint at least two statutory auditors*”. This system was mainly adopted to favor auditor independence, but it may also lead to lower audit market concentration.

In our research paper, we review empirical academic research on the economic consequences of mandatory joint audits in France. This research may be of great interest for European regulators, especially those from the Netherlands and the UK, where the introduction of such system is discussed.

What are the consequences on market concentration?

When considering the number of clients, the French audit market seems somewhat less concentrated than other European markets. However, over the period 2002-2017, French firms tend to select more Big Four firms, probably because non-Big Four firms have strong production constraints (i.e., lack of sufficient resources to perform the audit).

The percentage of fees captured by Big Four firms in France is nonetheless quite similar to that captured by these auditors in other countries, suggesting similar market concentration. This result reflects two facts. First, Big Four firms are hired by the largest French companies that pay higher audit fees. Second, Big Four firms capture a higher percentage of audit fees when they work with a non-Big Four firm (i.e., unbalanced work).

What are the consequences on audit quality?

Audit quality is generally defined as the joint probability that an auditor will detect and report a breach in financial reports. Advocates of the mandatory joint audits system state that joint audits may be associated with more knowledge/competencies (i.e., detection of a breach) because ‘four eyes are better than two’, as well as greater independence (i.e., reporting of a breach) because it is easier for two auditors to resist managerial pressure.

Empirical results suggest that the quality of financial statements (measured by accruals metrics) is not higher in France than in other European countries. Thus, joint audits are not associated with significant economic benefits in terms of financial reporting quality.

What are the consequences on audit fees?

Audit fees may be lower if joint audits favor competition (i.e., if joint audits lead to more competition, then more pressure from clients may lead to lower fees). However, it may also be associated with higher audit fees if additional costs are incurred by the two auditors to understand the entity and its environment, to assess the risk of material misstatement at the financial statement level, to develop (with the other auditor) a common audit approach and audit plan, and to review the work carried out by the co-auditor.

Empirical results show that French companies pay more audit fees than companies from other countries, which suggests that significant coordination costs between the two auditors are passed to the clients. Thus, joint audits are associated with significant additional costs.

Are the conclusions sensitive to the pair of auditors?

In 2010, the European Commission proposed to pair a Big Four with a non-Big Four firm, which is the combination the most frequently adopted in France. It is interesting to understand whether the quality-price ratio of audit services depends on the composition of the auditors' pair.

Empirical research shows that balanced work ('50-50') between a Big Four firm and a non-Big Four firm does not lead to a better quality-price ratio of audit services. In addition, large and complex firms generally hire two Big Four firms, because auditors' production constraints matter. Thus, imposing a pair composed of a Big Four with a non-Big Four firm may not have positive economic consequences.

What are the implications for regulators?

Overall, academic research suggests that the mandatory joint audits system is not efficient: the cost is higher (i.e. firms pay significant higher audit fees) without any significant improvement in audit quality. In addition, they do not reduce the market concentration, when it is measured with the percentage of audit fees captured by Big Four firms.

Moreover, the Danish experience suggests that the abandonment of the joint audits system reduces audit fees paid by the clients, without affecting audit quality. In other words, the quality-price ratio of audit services increases after the abandonment of such system, supporting the idea that mandatory joint audits are not efficient.

However, we note that joint audits may lead to different consequences in different contexts. Regulators interested by the introduction of a joint audits system should therefore consider the interactions between joint audits and other 'rules' (e.g., existence of audit committees, efficiency of internal controls, litigation risk, etc.). Substitution effects or complementary effects between joint audits and other 'rules' may ultimately affect the quality-price ratio of audit services.