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ARE FOUR EYES BETTER THAN TWO? AN EXAMINATION OF RECENT EMPIRICAL EVIDENCE ON THE IMPACT OF JOINT AUDITS

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Executive summary

On December 18, 2018, the Competition and Market Authority in the UK (CMA) published an update paper highlighting a number of concerns in the audit sector and proposing changes to legislation for the benefit of the savers and investors. Three key reforms were proposed: a spilt between audit and advisory business; regulatory scrutiny of auditor appointment and management; and encouraging more choice. The CMA proposed that audits of the FTSE 350 companies should be carried out by at least two firms, including one from outside the Big Four. Although joint audits are relatively uncommon, they exist, in different forms, in some countries in the world. Also, in recent times, countries such as Denmark, South Africa, and Canada have gone through regulatory reforms to eliminate the provision for a mandatory joint audit. Advantages of joint audits are seen in the potential reinforcement of auditor independence, and the strengthening of the market positions of the non-Big 4 firms. Opponents of joint audits are mainly concerned with the potentially high organization and coordination costs, as well as the possibility of free-riding and internal opinion shopping without a corresponding increase in audit quality. Empirical evidence on the impact of joint audits is limited and largely inconclusive. The objective of this report is to provide an objective analysis of recent empirical research on the impact of joint audits. Using recently published research extracted from academic databases, this report analyses the empirical evidence on the impact of joint audits on three key areas, namely: audit quality, audit fees, and audit market concentration. Also, responses to CMA (2018) consultation on statutory audit market are analysed.

The key findings of this literature review are as follows:

- Empirical studies offer very little support to the notion that the introduction of joint audits would result in better audit quality. Recent evidence on the other hand supports the established conclusion that joint audits do not have any impact on audit quality.

- Several studies, however, suggest that companies with joint auditors pay significantly higher audit fees as compared to companies in the single auditor regime. Also, a switch from joint audit to single audit results in cheaper audit costs but the single audit still offers the same audit quality.

- Although a number of empirical studies confirm the lower audit market concentration in France, the audit market for the larger French listed companies is still dominated by the Big 4 audit firms.

- In response to the recent consultations initiated by CMA, major stakeholders were generally opposed to the idea of introducing joint audit in the UK. Most respondents

cited cost of joint audit, audit complexity and the lack of evidence regarding the potential impact of joint audit on audit quality as their major concerns. The most frequently made arguments in support of the introduction of joint audits were: the enhancement of the audit experience base of non-Big 4 firms, 'proven' results in France and other EU countries, and a 'belief' that joint audits could be used to effect a change in the UK audit markets.

- The limited evidence on the impact of joint audit on key areas such as audit quality, audit pricing, and audit market concentration suggests the need for further research to support a policy position at a national level. Especially, future research in this area can benefit from the application of qualitative research methods to explore issues such as dynamics of relationship between the joint auditors, duplication of audit work, complexities in audit planning, including the determination of materiality thresholds by two different audit firms, as well as assumption of audit liability.

Are four eyes better than two? An examination of recent empirical evidence on the impact of joint audits

A. Context of the report

1. On December 18, 2018, the Competition and Market Authority in the UK (CMA) published an update paper highlighting a number of concerns in the audit sector and proposing changes to legislation for the benefit of savers and investors. Three key reforms were proposed: a spilt between audit and advisory business; regulatory scrutiny of auditor appointment and management; and encouraging more choice in the audit market. The CMA proposed that audits of the FTSE 350 companies should be carried out by at least two firms, including one from outside the Big Four. This was heralded as giving 'challenger' mid-tier firms access to the largest clients, allowing them to develop their experience and credibility while also ensuring a cross-check on quality (CMA, 2018). An alternative (even additional) proposed reform was the implementation of a market share cap – as a way of ensuring that some major audit contracts are only available to non-Big four firms.

2. Joint audits are relatively uncommon, and exist, in different forms, only in some countries. France has mandated joint audit since 1965. Similar provisions are also in place in countries such as Morocco, Kuwait, Congo and the Ivory Coast. Also, auditing by two independent auditors is mandatory in Saudi Arabia, Algeria and Tunisia. In recent times, a number of countries, such as Canada, Sweden, South Africa and Denmark have actually abolished provisions of mandatory joint-audit, and moved into a single audit system for a variety of reasons. Nevertheless, a voluntary form of joint audit exists and has been proposed in countries such as India, Italy, and the UK.

3. The EC Green Paper (EC 2010) highlighted concerns regarding high audit market concentration, and suggested the introduction of mandatory joint audit in the EU. In November 2011, a regulatory proposal issued by the EC encouraged the practice of joint audit on a voluntary, non-mandatory basis. This proposal was motivated by the recognition that the Big 4 firms dominated the audit market in the EU, except in France, where joint audit is mandatory (Huber, 2011).

4. Advantages of joint audits are seen in the potential reinforcement of auditor independence and the strengthening of the audit market positions of the non-Big 4 firms (Haak et al, 2018). Auditor independence can be improved because each auditor will have lower economic bonding with the client and it will be more difficult for managers to convince two auditors to remain silent on any discovered problem (Mazars 2010; Zerni, Haapama, Rvinen, and Niemi 2012). Opponents of joint audits are mainly concerned with the potentially high organization and coordination costs and the possibility of free riding and internal opinion shopping without a corresponding increase in audit quality (Neveling 2007; Deng et al, 2014).

5. In 2012, ICAS published a review of the existing evidence on the impact of joint audits on audit quality, audit pricing and audit market concentration. The ICAS

(2012) review found limited support for the argument that joint audits led to increased audit quality. Rather, some empirical evidence was found in support of the argument that joint audits would lead to a significant increase in audit costs. The report further highlighted the importance of viewing joint audits in a broader institutional context, as the impact of such arrangements dependent significantly on the way audits interacted with and impacted on various country-specific factors. The ICAS report pointed out that although joint audits could potentially enhance the level of competition in the audit market (by allowing smaller audit firms to maintain larger market shares), the impact of such lower market concentration on the quality of the audit had not been clearly demonstrated. The review highlighted the need for further evidence before the proposal for a mandatory joint audit should be implemented in the EU.

6. The ICAS (2012) report presented a summary of the main empirical studies investigating the impact of joint audit on audit quality, cost and market concentration. While it provided far from compelling supporting evidence for any mandatory implementation of joint audits, particularly in terms of the observed effects on audit quality, the ICAS (2012) report is now somewhat dated and there is a pressing need for a further review which encompasses more recent research in this area. This is especially important in the context of the recent reform proposals put forward by the CMA. The objective of this report is, therefore, to provide a summary of recent empirical research on the impact of joint audit on three key areas, namely: audit quality, audit fees, and audit market concentration.

B. The impact of joint audit on audit quality

7. Research studies have now investigated the impact of joint audit on audit quality in a number of different contexts. In virtually all cases, the studies are undertaken in a quantitative methodological fashion, using regression based analysis and large market and financial data sets to construct regression equations that measure the impact of joint audits on the chosen dependent variable, having controlled for a range of potentially intervening independent variables. In relation to studies of the impact of joint audits on audit quality, most studies utilise a proxy measure of audit quality in the form of what is commonly known as ‘abnormal’ accruals .

8. These empirical studies, whether pre- or post- the ICAS review, offer very little support to the argument that the introduction of joint audits would result in better audit quality. At the time of the ICAS review, the established conclusion, using a Danish setting, was that joint audits do not have any impact on audit quality (Holm and Thinggaard, 2011). Such results have been confirmed by more recent studies, Lesage et al. (2017). In a recent study, Holm and Thinggard (2018) found that in Denmark, a switch from joint audit involving two large audit firms to a single audit involving a big audit firm was prompted by the view that such single audits are significantly cheaper, and offer similar audit quality.

9. Lesage and Ratzinger-Sakel (2012) used a matched sample from France and Germany in an attempt to disentangle the impact of joint audit in France, where such an

arrangement is mandatory. This comparison reveals no significant difference in audit quality in these two countries.

10. There is some evidence outside of Europe of the positive impact of joint audit on audit quality. For example, in Kuwait, where joint audit is mandatory, Al Hadi et al (2016) reported that joint audits lead to a significant decrease in the audited company's cost of capital. The paper highlights that this is predominantly due to the uniqueness of the Kuwaiti market that allows rulers to be able to actively incorporate Royal Family members into the board of directors in listed companies, mostly due to their founding membership status in these companies. As such directors are not willing to be 'questioned' (Sidani and Al Ariss, 2014) which, in turn, creates significant risks for minority shareholders. A joint audit, especially involving a Big 4 audit firm, was felt, potentially, to be more effective in constraining such opportunistic behaviour through a more extensive audit practice. This paper provides support to ICAS (2012)'s observations that the impact of joint audit has to be assessed in a broad-based institutional context, as its impact could be significantly dependent on various country-specific factors. Lesage et al (2017) also note that attributing any across the board impact to joint audits is hard because it is not easy to isolate institutional factors specific to different countries.

C. Impact of joint audit on audit fees

11. Several studies have attempted to investigate the impact of joint audits on audit fees. Andre et al. (2017) compared the audit fees of listed companies in France, where joint audits are mandatory, with those paid by British and Italian companies, where such a regulatory requirement does not exist. The study found that that a French audit with at least one Big 4 audit firm would typically cost 35% to 70% more than an equivalent British or Italian Big 4 audit. Andre et al. considered whether a possible explanation for the observed audit fee differences could be that higher fees are being paid for higher quality audits in France. However, they duly found that the level of earnings management was not significantly different across the three countries. Hence, the higher audit fees paid by French companies were not associated with higher audit quality, but were a direct consequence of the mandatory joint audit requirement. Andre et al. (2017) reported a 35% to 70% increase in audit costs for joint audits, while Lesage et al. (2017) found that Danish companies with joint auditors paid around 10%–25% more than companies that chose to abandon joint audits and just have a single auditor.

12. Deng et al. (2014) argued that joint audits could be constrained by the problem of free-riding, wherein one of the joint auditors seeks to save resource cost by investing less in their own audit work, and take advantage of the other audit firm's harder work on the joint audit. In a theoretical analysis, Deng et al. considered three scenarios: single audit by a large (big = B) firm (regime B), joint audit by two large firms (regime BB) and a joint audit by a large and a small (= S) firm (regime BS). On the basis of a number of theoretical assumptions, the paper deduced that while audit quality could be expected to remain the same in BB and B regimes, the former (joint

audit) regime would result in lower audit fees. In comparing regimes BS and B, Deng et al. suggested that audit quality would be lower under regime BS. They also asserted that audit fees under joint audit regimes would be lower than single audits if the technological differences between the two auditors were small, and the large audit firm was prepared to bear a large proportion of the misstatement costs.

13. Holm and Thinngard (2016) empirically tested the theoretical predictions made by Deng et al (2014). Using 261 firm year observations from Danish listed companies, Holm and Thinngard (2016) found that, contrary to the predictions of Deng et al (2014), neither BB nor BS joint audits exhibited lower audit fees when compared to B single audits. This implied that coordination costs do have a significant effect on audit costs in the context of joint audits. Holm and Thinngard also found that, overall, joint audits with at least one big audit firm are not significantly more expensive than single audits performed by one big audit firm acting alone. In the case of a very unbalanced BS joint audit, when the big audit firm works with a very small audit firm who takes less than 25 per cent of the fees, they suggested that the audit fees would be higher than when the big audit firm worked alone on the audit. This suggested that in such a case, the big audit firm must be particularly concerned about potential free-riding by the small audit firm. The authors saw that an obvious practical implication of their work was for companies to take the lead and demand a more equally shared audit if they really wanted a BS joint audit. Otherwise they had clear incentives to dismiss the small audit firm.

14. Some studies have looked into the composition of joint audits and its impact on audit fees. In the context of France, Audousset-Coulier (2015) investigated how the selection of joint auditors influences the amount of audit fees paid. They found that in a joint-auditing environment, the choice of two Big 4 auditors did not lead to the payment of a 'double' Big 4 premium. A fee premium was paid but it did not differ significantly between companies that chose one Big 4 audit firm paired with a non-Big 4 audit firm and those companies that chose two Big 4 audit firms. This suggested that the Big 4 premium was somehow being shared between the two Big 4 firms when they were auditing jointly.

D. The impact of joint audit on audit market concentration

15. In its Green Paper, the EC (2010) suggested that joint audits could effectively reduce the high audit market concentration in Europe. Indeed, the lower degree of market concentration in France, compared to other parts of Europe, has been cited as a 'direct and desirable effect' (ICAS 2012) of a joint audits regulatory requirement.

16. A number of empirical studies (for example, Piot, 2007; Ballas and Fafaliou, 2008) have confirmed the lower audit market concentration in France. ICAS (2012) attributed some of this to events following the demise of Arthur Andersen. Whereas

other Big 4 audit firms took over Andersen audit clients in most European countries, some non-Big 4 firms assumed a number of these clients in France and Denmark, at a time when joint audit was mandatory in both countries. In a recent study, Kermiche and Piot (2016) supported the view that joint audits had been effective in maintaining market openness and mitigating Big 4 domination in the long run. Specifically, the paper reported that the "mixed" (large-small) joint-audit arrangement remained the most common combination, adopted by a majority of audit clients. However, empirical evidence suggests the Big 4 firms actually dominate the market for large, listed companies even in France (Broye, 2007). Piot (2008, as mentioned in ICAS, 2012) also report significant variation of audit market concentration across industries in France. For example, audit market concentration is high for certain industries, such as the construction, energy and commodities, and financial institutions.

17. The CMA (2018, p. 11) identified a number of large-medium sized audit firms able to play the role of 'challenger' firms. It envisaged that the provision of joint audits would help such challenger firms' access large audit clients and allow for a cross-check on audit quality. This view, however, has been challenged by Peterson (2019), who notes that such provisions would require significant investment by the challenger firms to be able to perform a significant body of additional audit work of a more complex nature. Also, such challenger firms would need the services of personnel who are skilled in tendering procedures.

E. Views of the stakeholders regarding joint audits: an analysis of responses to CMA consultation

18. In launching its most recent public consultation on the topic of statutory audit market in the UK, the CMA (2018) made explicit its concerns with audit quality and identified as one of the primary drivers of the consultation process. It noted a number of key problems relating to the UK audit market, with three key measures being highlighted as possible ways of addressing such problems. One of the three key measures related to increasing competition between non Big 4 firms in the UK through a market share cap and/or joint/shared audits. Question 23 of the consultation document focused explicitly on the possibility of introducing joint audits in the UK:

    Question 23. Could a joint audit be an effective means of implementing a market share cap?

19. A total of 77 responses were received from a diverse group of respondents. The section below comprises of an analysis of responses. For the purpose of this analysis, responses from the general public have been omitted. Table 1 presents below a brief breakdown of the responses to this question. A more detailed summary of the responses has been presented in appendix 1.

Table 1: Responses to question regarding joint audit

	Support	Qualified support	No comments	Qualified oppose	Oppose
Number of responses	5	10	21	8	17
% of total responses	8.20%	16.39%	34.43%	13.11%	27.87%
% of total responses (excluding 'no comments')	12.50%	25.00%		20.00%	42.50%

Table 1 indicates that the introduction of joint audits as a means of implementing a market share cap was supported by just 24.59% of the respondents, while 40.98% of the respondents opposed the idea, and 34.43% refrained from making a comment. If the respondents not choosing to comment are excluded from the analysis, there is an even more prominent opposition (62.50%) to the introduction of joint audit in the UK. The support for the proposal mainly comes from medium sized audit firms[1], whereas the Big 4 audit firms and FTSE 100 UK companies predominantly oppose such a move. Hence, on the basis of an initial analysis, it appears that the majority of the respondents are opposed to the idea of a joint audit as a means of reducing audit market concentration in the UK.

20. Table 2 ranks the arguments in terms of number to times they were mentioned by respondents opposing joint audit:

Table 2: Arguments for opposing joint audits

Rank	Arguments
1	*More expensive due to duplication of work*
2	*Increase complexity*
3	*Lack of convincing evidence regarding its impact on quality*
4	*Time consuming*
5	*Lack of clarity regarding how joint audits will enable the smaller firm to take on the larger audits themselves*
6	*Confusion regarding audit liability*
7	*Creates significant risk*
8	*Not have sufficient impact*
9	*Inefficient*
10	*Do not lead to increases in competition*

Table 2 indicates that the cost of joint audits, their complexity and the lack of evidence regarding the potential impact of such audits on audit quality were the major concerns identified by respondents. This is consistent with the analysis presented in the earlier part of

[1] For the purpose of this report, the 2018 AccountancyAge top 50+50 accountancy firms ranking (excluding the Big 4) list is used for identifying medium sized audit firms in the UK

this report – which suggests that while some empirical evidence can be found in support of the argument that joint audits lead to an increase in audit costs, there is very little evidence of any positive impact on audit quality.

21. Table 3 ranks the arguments put forward by the proponents of joint audit:

Table 3: Arguments in favour of joint audits

Rank	Arguments
1	*Enhance the experience of professionals at mid-tier firms*
	Proven results in France and other EU countries.
2	*Less market failure in France*
3	*Belief that use of the joint audit and/or shared audit models could be used to effect change*
	Promotes better quality outcomes
	Ensures a higher level of rigour and independence
4	*This would help mid-tier firms to generate more fees a*
	Lead to Big-four firms ensure high file quality as they wouldn't want to present lower quality work to another firm
	Will lead to greater competition and resilience in the market
	Results in a more dynamic market

22. The most frequently made arguments in support of the introduction of joint audit are: the enhancement of experience of non-Big 4 firms; proven results in France and other EU countries; and a 'belief' that joint audit models could be used to effect a change in the UK audit markets. Interestingly, unlike the arguments put forward by the respondents opposing such measure, these arguments have limited empirical support. As discussed in earlier sections of this report, although joint audits have resulted in lower audit market concentration in France, there is hardly any evidence of the actual impact of such a measure on audit quality, and independence.

F. Conclusion

23. This report has analysed recent research and related evidence on the impact of joint audits, considering in turn the empirical evidence regarding the relationship between joint audits and the three key dimensions of audit quality, audit fees, and audit market concentration.

24. Empirical studies offer very little support to the notion that the introduction of joint audits would result in better audit quality. Recent evidence on the other hand supports the established conclusion that joint audits do not have any impact on audit quality. Some evidence exists outside Europe of the positive impact of joint audit on audit quality, but the strength of this evidence needs to be considered carefully and it is quite likely that the impact of joint audits is heavily connected to the nature of the

broader institutional context in which it is practised, including the importance of various country-specific factors and cultural influences.

25. Several studies suggest that companies with joint auditors pay significantly higher audit fees as compared to companies in the single auditor regime. Also, a switch from joint audit to single audit results in cheaper audit costs without but the single audit still offers the same audit quality.. There is an argument to suggest that joint audits could cost less than they currently do if the free-rider problem could be adequately tackled. Some recent studies have looked into the composition of joint audits and the impact on audit fees. In the cases where two Big 4 auditors are involved in a joint audit, the Big 4 premium would appear to be being shared between the two firms.

26. In terms of audit market concentration, a number of empirical studies have confirmed that the mandatory provision for joint audits has resulted in lower market concentration levels in France, with the market share of the Big 4 firms not being as high as in other countries. However, in France, audit market concentration varies significantly across industries, with Big 4 firms still conducting the majority of audits for large, listed companies.

27. In response to the recent consultations initiated by CMA, major stakeholders were generally opposed to the idea of introducing joint audit in the UK. The cost of joint audits (due to the duplication of audit work), audit complexity and the lack of evidence regarding the potential impact of joint audits on audit quality were the major concerns identified by respondents. The most frequently made arguments in support of the introduction of joint audits were: the enhanced market engagement of non-Big 4 firms, proven results in France and other EU countries, and a 'belief' that joint audit models could be used to effect a change in the UK audit markets.

28. A striking aspect of the research relating to the impact of joint audits is that it is dominated by the application of quantitative research methods, and the use of archival data. While the research published to date and the determined effects of joint audits in key areas such as audit quality, audit pricing, and audit market concentration do not lend any compelling support for the mandatory implementation of joint audits and certainly urge caution in this regard, it also has to be said that compared to other audit research topics, the scale of academic study is comparatively limited. There is certainly scope to pursue a qualitative research approach in this area in order to explore further issues such as the dynamics of the relationship between joint auditors, the scale of duplication of audit work, the practical complexities of audit planning, including the determination of materiality thresholds by two different audit firms, and the handling of assumptions and arrangements regarding auditor liability. Some such evidence also does not need to be restricted to jurisdictions where joint audits are mandatory – it could come from voluntary joint audit assignments for companies and audit firms keen to experiment with such an approach prior to any further consideration of its empirical merits.

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Appendix 1: Analysis of responses to CMA (2018) consultation

	Respondents	Support	Qualified support	No comment	Qualified oppose	Oppose
1	*100 Group of Finance Directors*					X
2	*ACCA*				X	
3	*Association of practicing accountants*	X				
4	*BDO*					X
5	*BHP*			X		
6	*Audit Scotland*			X		
7	*Blick Rothenberg Audit LLP*			X		
8	*ICAI*			X		
9	*CIMA*					X
10	*Cliff Weight*			X		
11	*The Confederation of British Industry*		X			
12	*Croda PLC*			X		
13	*Crowe LLP*		X			
14	*Deloitte*					X
15	*Duncan and Topliss*		X			
16	*Easyjet*			X		
17	*EY*				X	
18	*Filip Lyapov,*		X			
19	*Galifor Try*				X	
20	*Grant Thornton*		X			
21	*Hermes*			X		
22	*HKICPA*			X		
23	*HSBC*					X
24	*ICAEW*		X			
25	*ICAS*				X	
26	*ICSA*					X
27	*Intermediate Capital Group PLC and Daily Mail*					X
28	*IFAC*			X		
29	*Invesco*					X
30	*James Winstanley*			X		
31	*Johnson Mathey*			X		
32	*Johnston Carmichael LLP Scotland*					X
33	*KPMG*				X	
34	*Kreeston Reeves*			X		
35	*Legal and general investment management*			X		
36	*Lloyds*					X

37	*Local authority pension fund*	X				
38	*Mazars*	X				
39	*Mediclinic*			X		
40	*Moore Stephens*	X				
41	*Nationwide*					X
42	*Nexia Smith and Williamson*		X			
43	*Pensions and lifetime savings association*			X		
44	*Perendie*					X
45	*PWC*				X	
46	*RBS*					X
47	*Robert Conway*			X		
48	*RSM*	X				
49	*Russ Houlden*			X		
50	*Santander*					X
51	*Sarasin and partners*		X			
52	*Schroders*					X
53	*SD Barber*					X
54	*Serco*					X
55	*Simon Laffin*			X		
56	*Standard Life*				X	
57	*Association of investment companies*			X		
58	*Investment association*				X	
59	*UK shareholders association*			X		
60	*USS*		X	X		
61	*Wellcome Trust*		X			