

Discussion paper on joint audit – the Netherlands’ case study

1. Background

In its report ‘Rely on control’ (‘Vertrouwen op controle’), the ‘Committee on the future of audit’ (‘Commissie toekomst accountancy’ (Cta)) recommended to provide a mandate to the ‘quartermasters’ (‘kwartiermakers’) to engage in additional research on existing, alternative structures, including joint audit in the Netherlands. The Cta referred to earlier reports of the ‘Monitoring Committee on audit’ (‘Monitoring Commissie Accountancy’). As the impact of joint audits on quality is unclear - as positive, negative and neutral effects are reported - the Cta asked the ‘quartermasters’ to commission studies to evaluate the impact on quality in more detail as well as to include international experience.

European Investors/VEB is most willing to assist in the delivery of a more thorough analysis, based on available international research. Considering the correlation with concentration and competition issues, our analysis will start with that.

2. Main conclusions

Lack of comparable and reliable data

The audit profession is a global profession, dominated by a few large audit firms, with audit standards developed predominantly by and via those firms themselves. Furthermore, the execution of their work is commoditized and subject to competition on dedication to quality (professional skepticism and experience) and time (team size, dedicated hours). Consequently, audit firms are organized in comparable structures.

Over the last decade, politicians and the public allowed the sector the necessary leeway and trusted on the sector’s own initiatives, good intentions, invested in more independent supervision and provided the time to audit firm leadership to manage a culture change within their organizations. However, the conclusion from the most recent analyses (further outlined below) is becoming clear. A structure change is needed – or should at least be tested – to find a solution that works and to overcome wicked problems and audit quality failure.

As the sector is currently holding on to *status quo*, i.e. the structure they are most familiar with, it turns out to be very hard to collect and interpret data on the pros and cons of alternative structures and to measure the impact thereof on audit quality. Hence, European Investors/VEB is supportive to start with pilots on alternative structures, including joint audit.

However, based on a recent and more detailed analysis from the world's largest and most developed jurisdictions (see the IFIAR report included in the Annex, with specific focus on market concentration and joint audit), an analysis actively supported by European Investors/VEB, the intuitive thinking is that the introduction of a joint audit, shared audit or mandated audit, might not bring the most significant benefits in terms of audit quality. Below, the most relevant elements of international analyses are included. However, with more comparable and reliable data, this intuitive thinking and yet unfounded draft conclusion might prove to be wrong. Likewise, according to European Investors/VEB, other suggested alternative structures should be piloted and tested with the same rigor.

A good quality audit is key; consistent execution remains a key challenge

While progress has been made, the intermediary role of trust provider by auditors continues to be an important area of focus, such that reliable financial reporting contributes effectively to the important allocation of capital and risk between companies and investors. Major accounting and audit incidents with often significant repercussions for financial markets and economies of countries involved, continue to appear in many jurisdictions. The most recent example being Wirecard in Germany, but other recent examples such as Steinhoff, Carillion and Toshiba could be quoted as well. And more are likely to follow.

Despite many efforts by legislators, regulators, and firms alike, audit quality is not where it should be. The latest Inspection Findings surveys of IFIAR, combining the inspection results of the world's largest and most developed jurisdictions, still raise concerns about persistent rates of inspection findings. The surveys show a downward trend over the years in terms of inspected audits with one or more significant findings. IFIAR concludes that the percentage audits inspected with one or more findings has dropped from 47% in 2014 to 33% in the 2019 Survey. While encouraged by the continuing trend, audit firms are urged for continuing the efforts to achieve improved audit performance. The current rate of 33% is still very high. As such, it is clear that further efforts to ensure consistent execution of high-quality audits continue to need attention and focus. Clear reduction targets are needed, and structural improvements required.

Joint audit is a common reality

One of the structural improvements considered in certain jurisdictions is the introduction of a joint audit requirement. Joint audit involves more than one audit firm taking responsibility for the performance of the audit of a given entity. Depending on the regulation in place, this usually involves two audit firms working together to provide a joint opinion after challenging each other and cooperating to assess jointly the choices made by the entity's management when preparing the financial statements. The use of joint audit remains marginal. Joint audit requires a cross review of the audit work by the other auditor ("two sets of eyes" approach) in a challenging approach between the audit firms. This is believed to lead to greater auditor impartiality *vis-à-vis* the audited entity, an increase in technical competence of audit firms by sharing experience, increased continuity of the audit and increased resilience, competition and opening up of the audit market, leading ultimately to better audit quality.

From a practical perspective, joint audit is nothing new. Currently, the larger audits are performed by a team of auditors each responsible for different jurisdictions or regions. The lead engagement partner is required to instruct in detail and review with rigor the component audits performed by different auditors and their teams. In all circumstances where the burden of audit work is shared among different actors, European Investors/VEB would consider this a joint or shared audit, irrespective whether the same or different brand names are on the façade.

We understand that for obvious reasons, these partners prefer to work for the same audit firm. On the one hand, it is in their interest to prevent competition on referred-in audit work. On the other hand, fragmentation in the methodology of planning, risk analysis and execution is prevented which is in the interest of the audited company and its stakeholders. However, there are many examples and reasons a global audit performed by a single audit firm is not possible or suboptimal. For instance, if the quality of the auditor in a certain region or past performance *vis-à-vis* fraud and corruption was such that a specific audit firm is no longer allowed to audit in that region. The latter situation was for certain types of audits the new reality for KPMG in South Africa.

Under the current standards, material components could be audited by auditors from a different brand without any problems. Also, for smaller firms, absent global presence, a joint audit with other firms or mandated audits for a specific component is common practice. In some jurisdictions, measures which address concentration have been put in place or are being envisaged, including joint audits (see section 5C). Although a significant majority of jurisdictions does not have in place a regulation requiring a mandatory joint audit model for at least certain audits, a limited number of jurisdictions do, such as France. Others allow joint audit without imposing an obligation, like in South Africa. Furthermore, the introduction of joint audits and shared audits is under consideration in a number of other jurisdictions, such as the Netherlands and the UK.

A more realistic view on the pros and cons of joint audit

In the analysis of pros (and cons), the argument is often used that two sets of eyes can see more. However, a pure joint/shared audit, such that all audit work is performed twice – by two independent teams -, has not been the reality in any jurisdiction. The possible pro is therefore limited to the cross review of the audit work by the other auditor/engagement partner. Independent inspection reports indicate that precisely that review, in practice, is not consistently performed with the professional skepticism required (NV-COS 600 group audit failures). Furthermore, the added value of additional audit quality review ('OKB' in the Netherlands) has limited impact on *ex-ante* detection of audit failures. Hence, the added value of joint audits should not be overestimated. At the same time, the shortcomings in practice require structural adjustments. European Investors/VEB is open to learn from experiences from pilots in this area.

Considering the above, the real question on this element of structural economic failure is whether there is a lack of competition in the audit sector which has a negative impact on quality. The latter causal relationship should be analyzed in detail. This neatly coincides with the recommendation of the Cta. Will the introduction of a joint audit requirement stimulate a more consistent performance and high-quality audit? That is the key question. All other observations and reflections on competition in the market are in our view of less importance. Considering the public interest reflected in the audit and the global stage of affairs, European Investors/VEB is not so much worried about concentration in the market. Be it that in such a concentrated market subsequent as well as alternative market failures must be addressed, and the negative impact mitigated.

Market concentration debate has a long history

In most jurisdictions, statutory audits for Public Interest Entities (PIEs) are performed primarily, or in large part, by a small number of networks (“Big Four” or fewer). Deloitte, EY, KPMG and PwC together hold a prominent market share in auditing services. For instance, available studies of 2017 show that, in the European Union, the “Big Four” firms together had an average market share of almost 70% in number of statutory audits of PIEs. In the United Kingdom, these firms were the statutory auditor for 82% of all PIEs in 2018. Consequently, the impact of market concentration and competition has been, or is being, under scrutiny in some countries/regions (see section 5C). As such, one should consider that these issues have already been under debate for at least 44 years.

For European Investors/VEB it is still unclear whether the degree of market concentration is a topical issue across all sectors. We do see concentration issues in the segment of the audit market relating to listed companies or other PIEs. Specific considerations relate to niches in the market for PIE audits, where expertise, size or technology barriers may limit the range of audit firms available. On the other hand, we see that there are elements of a natural oligopoly or quasi monopoly, where audit firms need to have size and global presence to be able to audit large multinationals.

Too big to fail may introduce complacency and lower quality

An often mentioned reason for concern regarding audit concentration seems to relate to the “too big (or: too few) to fail” doctrine in highly concentrated markets. With respect to the audit markets, in case of the failure and disappearance of one or more of the “Big Four” firms, doubts and worries can indeed be raised about the limited number of large audit firms remaining to compete for large audit engagements. As such, concentration is often seen as a problem from a competition point of view, while some regulators note concerns about market resilience as well. Another key concern, however, is that lack of competition may make audit firms complacent, potentially lowering audit quality.

A mixed picture on pros and cons of concentration

Academic studies dealing with audit market concentration provide a mixed picture, by highlighting positive consequences as well as negative consequences on the audit services provided. However, a recurring concern raised with respect to market concentration is the decrease in options for choosing among a too limited number of audit firms, which is a matter for consideration by competition authorities. Also, the weight of a positive and negative impact of concentration on audit quality may depend on the market segments. In the large-client segment, multinational entities may benefit from large audit firms able to provide them with technology- and resource-intensive audits. On the other hand, smaller entities and businesses acting on a national basis, whose less complex audits may involve fewer resources, may see a higher benefit in a larger variety of audit firms.

Audit Committees have a key role to play

Lack of choice and vulnerability to complacency are natural features of an oligopoly or quasi monopoly. However, not only the way audit firms organized and merged themselves into this reality is reason for worry. The suboptimal engagement practice of audit committees is as significant.

One of the key responsibilities of an audit committee is to manage the engagement with the external auditor. Historically, the engagement term was less relevant and the lack of choice not so much considered a pressing issue. However, too many examples of a too cozy relationship between executive management and auditor opened the eyes of regulators and politicians. Consequently, to reestablish the independence of the auditor, the engagement term was maximized at firm level and the combination of audit and (tax) advisory work curbed. Despite this new reality, many audit committees have themselves confronted with a lack of willingness of audit firms to engage in an audit tender. In practice, audit committees complain about that lack of willingness and the limited choice audit committees consequently have. It is, however, not a lack of choice, but more a lack of leadership, strength, creativity and independence at the level of audit committees. Audit committees too often bark at the wrong tree.

Audit firms often prefer not to seriously engage in the audit tender to maintain and defend their advisory or tax advice revenue stream at client level. To be able to present a choice between two audit firms to the general meeting of shareholders, in accordance with mandatory EU regulation, audit committees must anticipate rotation on time and be more firm *vis-à-vis* audit firms. Hence, the tender procedure must start at least two years prior to the effective date of rotation to force all audit firms to participate in the tender if they want to (i) win the audit engagement or (ii) still be considered a reliable and preferred partner to provide advisory or tax work. A two year transition term would facilitate a real choice for the audit committee, the necessary continuity of service delivery and compliance with independence requirements. European Investors/VEB is very much motivated to challenge audit committees on how they have organized the engagement with the external auditor. Introducing joint, shared or mandated audits without strengthening an existing sub-optimal engagement practice, would be ill-considered from the outset.

European Investors/VEB is supportive to start with pilots on alternative structures, including joint audit, considering the observations in this contribution as we cannot afford not to seize the opportunity to dig into all possible solutions to strengthen audit quality and the consistency thereof.

3. A more detailed view on the structure of audit markets

High concentration

Although significant progress has been made, it is fair to say that audit markets around the world are still characterized by certain longstanding, deep-seated and intractable features. Over the course of time, the supply in audit markets has decreased from eight major players to currently four major players, as measured by market capitalization of companies audited. High concentration among four big audit firms generally results in limited choice for larger, multinational audited entities. Generally, in such an environment, the risk is that the overall output does not serve public needs very well.

Quality is a black box for all others than regulators

Also, high audit quality, despite being the overriding outcome desired from the market, is hard to judge (an audit is, in economic terms, a credence good). Indeed, shareholders and debt providers, for instance, are generally not in a position to properly monitor, evaluate and compare the quality of audits and auditors and therefore are not able to take action in cases where audit quality is not adequate. Furthermore, auditors are being selected and paid for by the companies they audit, while the ultimate beneficiaries of a good-quality audit typically *de facto* have no role in selecting auditors.

Many jurisdictions have sought to address this by making independent audit committees responsible for the auditor selection process. Whilst there are many examples of strong audit committee roles, there are also indications (both in academic literature and in practice) suggesting that in many cases the management of audited companies can still influence the appointment of the auditor (and the termination of the engagement) and that audit committees may not be sufficiently independent in these situations. Finally, the largest audit firms are increasingly operating as multidisciplinary firms, with non-audit work generally being the main source of revenues and profits within these firms. Achieving lasting changes in audit quality in this environment is difficult and puts pressure on the effectiveness of supervision. Indeed, these features are not new and have been an issue top of mind of stakeholders in the audit industry around the world over the last decades.

Structural market failures need to be addressed

These characteristics of the structure of the audit markets create incentives that may negatively impact audit quality, although the robustness of the underlying (academic) evidence for this relationship between structure and audit quality varies. In its report in 2018, the AFM observed that the indications for a negative impact of these structural features on the quality of statutory audits apply mainly to the fact that audit firms are selected by and paid for by the companies they audit, and to the combination of non-audit with audit services within audit firms. There is also some evidence that the limited monitoring and disciplining by shareholders and debt providers may negatively affect audit quality.¹

In many jurisdictions around the world, for instance in the UK, the Netherlands, and South Africa, there is ongoing debate in the public domain with respect to the role (changes in) the structure of audit markets could play in improving the quality of statutory audits. Indeed, policy makers, supervisors, regulators, as well as academics, are discussing the feasibility and desirability of various reform measures and interventions aimed at the structure of audit markets, which could be implemented to alleviate these concerns on audit quality.

However, little or no experience with these reform measures has been gained as very few countries have already implemented them. And where data is available, the specific context would often not allow for general conclusions. This implies, unfortunately, that there is very limited data and academic research available to ascertain whether these reforms will indeed lead to high and sustained quality of statutory audits. On the other hand, this means that at this point in time, the potential effectiveness of these reform measures cannot be dismissed out of hand.

Generally speaking, based on anecdotal evidence derived from various case studies, and a theoretical analysis of pros and cons of reform measures which are being contemplated in certain jurisdictions, and taking into account their proportionality and effectiveness, various measures are being considered for their potential contribution to audit quality. These measures include the introduction of joint or shared audits, reducing barriers to entry in the PIE audit market and stimulating the build-up of market capacity in non-Big 4 firms.

¹ AFM, Vulnerabilities in the structure of the audit sector, November 2018.

4. Going forward

Sustainable and consistent high quality of statutory audits is an important element of reliable financial reporting that contributes to a properly functioning financial system. In the period ahead, all stakeholders in the audit industry stand to gain from developing a better understanding of the relationship between reforms addressing the structure of the audit markets and/or audit firms and audit quality. It will take further study and analysis to understand the impact on audit quality of measures being considered or implemented by various jurisdictions. Currently, in different jurisdictions, most notably the UK and the Netherlands, experience is being gained through experiments and pilots with alternative models for structuring the sector and/or individual audit firms. These experiments and pilots will offer opportunities for such studies and to learn. Although research undertaken is generally case specific and fairly narrow, having independent data and evidence is key for decision makers. All this seeks to stimulate a continued and important public policy debate on these issues, aimed at the overall goal of achieving sustainable and consistent high quality of statutory audits globally. European Investors/VEB would support academia's analysis and scrutiny of measures being implemented, their effects and impact, their conditions for success, and to do so not only on a jurisdictional basis but also from a holistic point of view.

Before presenting facts and findings related to market concentration, four general caveats apply:

1. Absence of data on market concentration globally. Data on the market share in audit markets are often available at jurisdictional level. No worldwide figures are available yet.
2. A variety of indicators are used to determine audit market concentration, implying that there is no single and shared approach for assessing concentration levels. Market share can be calculated in several ways: by number of engagements, by number of clients, by level of fees generated, or by market capitalization represented by the audited clients. Some of the figures relate to the full audit market, or only for parts of the audit market, *e.g.* the audit of listed companies, banks and insurance companies and other entities identified as PIEs at national level. As such, there is no single and shared approach for assessing concentration levels. At the same time, it is noticeable that the Big 4 audit firms nearly always dominate audit fees for both audit and non-audit services. This suggests a market where the largest firms dominate the most lucrative clients and create serious barriers to entry.
3. Segmentation of the market. The market for audit services can be segmented (*e.g.*, audits of large multinational corporations, audits of smaller listed entities, audits of unlisted public interest entities), and concentration can look very different among the various segments of the market.
4. Turnover from audit and non-audit services are often aggregated in the figures. It should be noted that the turnovers of the audit firms are not only generated by audit fees, since audit firms are not "pure players". They very often deliver services in other markets than the market of statutory audit (for example by providing accounting services, consulting, IT, tax, legal, transaction services).

This adds to the complexity in consolidating or assessing concentration.

5. Overview of market concentration in various jurisdictions

In many jurisdictions, Deloitte, EY, KPMG and PwC (the “Big Four” firms) together hold a prominent market share in auditing services. This situation is not new. The “Big Four” firms’ prominence has evolved following a series of mergers of large, global audit firms in the late 20th century through the demise of the Arthur Anderson network following the 2001 Enron scandal. Indeed, one of the drivers for global audit networks mergers was to enable sufficient investment and scale to perform audits required by large and complex multinational companies.

Europe

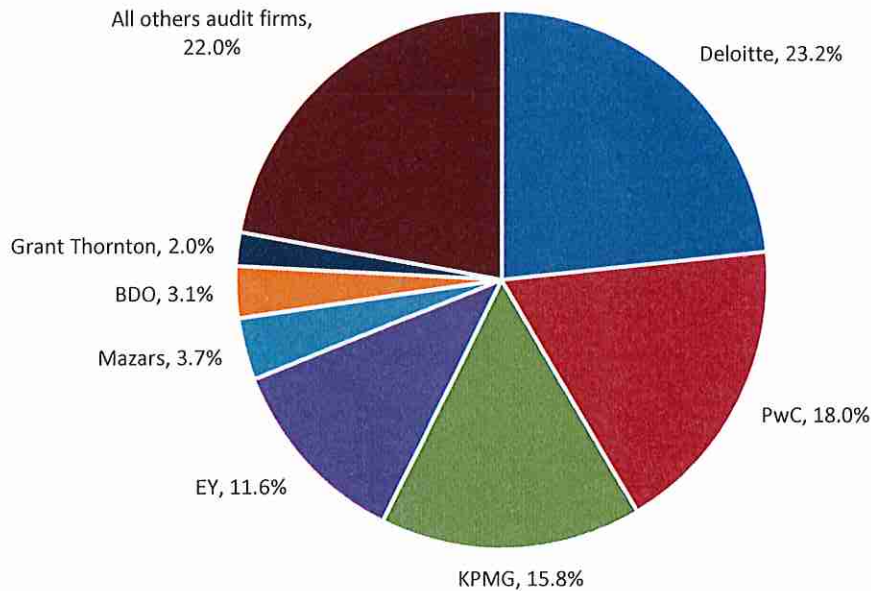
Available studies of 2017 show that, in the European Union, the “Big Four” firms together had an average market share of almost 70% in number of statutory audits of PIEs.² The main player in the PIE audit market, Deloitte, alone had a nearly one-fourth market share (23%) and the second one, PwC, had a nearly one-fifth market share (18%) (see figure 1.1). Taking turnover as the reference, the market share of the “Big Four” was calculated around 80%.³

Turning to individual member states, the same picture arises. The “Big Four” are the largest audit firms in most EU member states. The European Commission concluded that they constitute a concentrated oligopoly in 15 states. Their combined market share in turnover even exceeds 90% in six member states.

² Report on monitoring developments in the EU market for providing statutory audit services to public-interest entities pursuant to Article 27 of Regulation (EU) 537/2014, European Commission, September 2017

³ Based on 21 countries figures, out of 28 EU members.

Figure 1.1: Market share for statutory audits of PIEs (all EU member states)



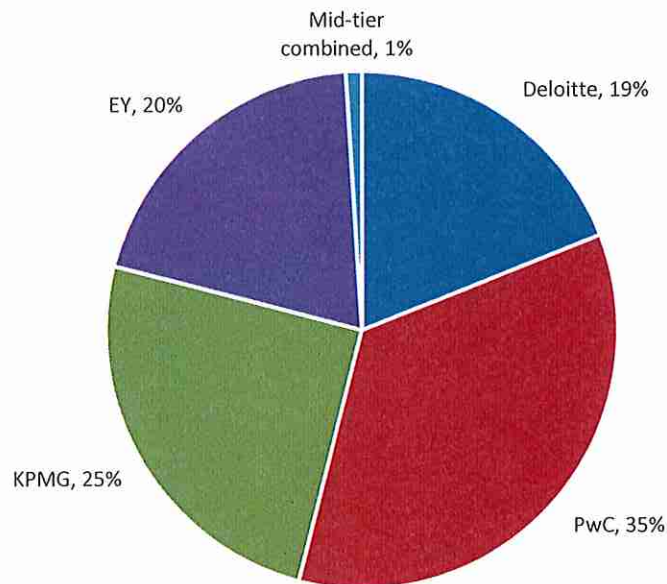
UK

In the United Kingdom, the “Big Four” firms were the statutory auditor for 82% of all PIEs in 2018⁴. The next five largest firms perform the statutory audit for 13% of all PIEs, meaning that the nine biggest audit firms held a 95% market share. The UK also notes an increase in that all main market companies are being audited by the Big-4 and next five firms in 2018. The combined share of the “Big Four” firms was even greater in terms of their share of audit fees paid by FTSE 350 companies.⁵ The “Big Four” firms received more than 99% of the audit fees paid in 2018, and other firms combined had less than a 1% share. The audit firm with the largest share, PwC, received more than one-third (35%) of all audit fees for this segment of the audit market (see figure 1.2). The “Big Four” firms also held a sizeable market share among the smaller listed companies. The share of audits carried out by the Big Four in the FTSE Small index was 89% in 2017, which corresponded to 92% of the total audit fees paid by these companies in the same year.

⁴ Key Facts and Trends 2019 Report, UK Financial Reporting Council, October 2019

⁵ The FTSE 350 Index is a stock market index incorporating the largest 350 companies by capitalization which have their primary listing on the London Stock Exchange.

Figure 1.2: Audit firm shares of UK FTSE 350 audit fees



North America

Compared to the UK, audit firms other than the “Big Four” more frequently serve as the auditors of listed companies in the US and Canada. For example, in the US, twelve audit firms served as auditors for 100 or more companies trading on US exchanges, thereby meeting for 2019 the requirement under US law to be subject to annual regulatory inspections.

It should be noted though that the US’s market is also significantly different – listings are much more common for smaller entities, where in Europe such companies typically do not rely on listing for funding. As such, the market of listed companies is larger and more diverse with respect to the size of listed entities, with non-Big Four audit firms auditing commensurately more of these entities compared to Europe.

A. Market concentration risk

A consideration regarding the level of market concentration is the implication to auditor choice. Indeed, in case of the failure and disappearance of one or more of the “Big Four” firms, few large audit firms would remain to compete for large audit engagements. As such, concentration is often seen as a problem from the competition point of view, and some regulators note concerns about market resilience as well. Too high a concentration would mean limited or absent choice for the audited companies. Another potential concern is that lack of competition may make audit firms complacent, possibly lowering audit quality.

At the same time, there is yet not enough (academic or practical) evidence on the nature of the relationship between concentration levels and audit quality (see box 1.1).

Box 1.1: Overview of academic studies on market concentration, audit quality and choice⁶

Academic studies dealing with audit market concentration provide a mixed picture of positive as well as negative consequences on the audit services provided. It should be noted that there is no single definition of audit quality or commonly accepted measures of audit quality. This absence of a point of reference makes it challenging to draw a correlation between a given level of audit market concentration and the quality of audit services provided in this market. Separately, a recurring consideration with respect to market concentration is the number of options if there are a limited number of audit firms, which is a topic within the remit of competition authorities.

The following benefits of market concentration have been highlighted in academic literature:

- ❖ Higher market concentration and larger audit firms are logically connected. Larger firms may have, compared to smaller firms, more financial resources likely to devote to human capital development. As such, they are able to invest and expand the knowledge and technical skills of their staff.
- ❖ More staff in larger audit firms inherently implies more auditors with specialized knowledge. Larger firms with specialized expertise in given topics allows them to address a larger range of audit engagements.
- ❖ Larger audit firms, through pooling greater resources, may invest more in information technology, which is likely to lead to operational efficiency.
- ❖ Larger audit firms depend less on a single client than smaller or medium-sized audit firms and they are less likely to become lenient with their clients, as the temptation to please them by compromising audit procedures is lowered.
- ❖ A concentrated audit market with larger firms creates economies of scale, enabling auditors to reduce costs and fees.
- ❖ As competition is lower in a concentrated market, there may be less downward pressure on audit pricing. Higher audit fees are likely to allow an increase the audit time spent, and as such the depth of the audit effort.

Other academic studies raise the following potential downsides of market concentration:

- ❖ Specialization of skills may concentrate high expertise in some few large audit networks, creating a gap between the large networks and the remaining smaller firms.

⁶ See literature list in Annex.

- ❖ In a concentrated market, fewer firms lead to a more constrained choice. Audit firms with significant market power may reduce the level of their services, as the lack of alternative solutions would limit their clients' ability to obtain audit services elsewhere.
- ❖ If big firms purge their portfolio of the riskiest audit clients, those clients have fewer alternative auditors to choose from. Also comments are being made of whether the small firms have access to the necessary capabilities for auditing such risky clients.
- ❖ In the absence of competition, large firms may not have an interest in investing in IT innovations that lead to operational efficiency as they may not have to differentiate themselves to gain new clients.
- ❖ Due to the reduced probability of the client switching auditors, auditors' long association with clients could result in a familiar relationship, leading to potential auditor complacency.

The weight of positive and negative impacts of concentration on audit quality or choice may depend on the market segments. In the large-client segment, multinational entities may benefit from large audit firms able to provide them with technology- and resource-intensive audits. On the other hand, smaller entities and businesses acting on a national basis, whose less complex audits involve less resources, may see a higher benefit in a larger variety of audit firms.

Lastly, some academic studies have highlighted that concentrated audit markets can remain price and quality competitive if audit clients are sufficiently mobile. The reduced competition, as long as the market share instability remains high, may not be concerning. Only a stable market with reduced mobility would be detrimental to audit "captive" clients.

B. Reforms addressing market concentration concerns: Joint Audit

Joint audit is one of the measures which may have a deconcentrating effect on the market. The large majority of jurisdictions do not have any regulation in place requiring joint audit in any circumstances. Some jurisdictions, including South Africa, allow for joint audit without requiring it. Yet, in these cases, the use of joint audit remains marginal.

Nevertheless, in a few jurisdictions, legislation creating a compulsory joint audit regime for some categories of entities applies, including France. These countries indeed show a lower market concentration than average in the European Union.

The level of correlation between the joint audit regime and market concentration is likely to depend on the scope of the joint audit obligation in the respective jurisdiction. If joint audit is mandatory and widely applied, its potential to deconcentrate the market is inherently higher than joint audit as only a voluntary option offered to entities, without any legal obligation.

In France, 55% of the PIE engagements is audited by "Big Four" firms. This does, however, not mean that in all those cases other firms than "Big Four" participate in the joint audit. In fact, in 51% of the cases both sides on the joint audit are "Big Four" firms. In 48% of the cases one "Big Four" and one other firm (often

Mazars) engage in the audit. **Just 2% had no “Big Four” firm involvement at all.** Irrespective the potential for greater auditor impartiality and other benefits, European Investors/VEB would like to highlight its skepticism *vis-à-vis* the general belief that France introduced a compulsory joint audit to stimulate fair competition and better access to the audit market.

Box 1.2: Joint audit in France

In France, a joint audit leads to a joint opinion on the financial statements. The joint auditors perform a joint examination of the financial statements. They communicate jointly with the entity and together sign a single audit report. They act together as a “college”, and are jointly responsible for the audit opinion issued.

A specific professional standard deals with the organization of joint audits in order to avoid any duplication of work and guarantee a balanced distribution of the audit work. External inspections are performed by the regulator to ensure proper collegiality and balance in the allocation of work, so that each auditor is able to form its own independent opinion and each of the two auditors sign the audit report.

Any audit firm can apply for an engagement as joint auditor, taking into account that joint auditors of an entity cannot be members of the same audit firm. The audited entity selects each auditor separately and creates its pair of auditors. Apart from independence between them, there is no legal obligation regarding the composition of the pair of auditors in terms of size of market share.

The minimum duration of an audit engagement in France is six financial years. This provision protects the auditor’s independence, especially against any attempts from clients to change the auditor in case of issuance of an adverse opinion. The six years duration also incentivizes smaller firms to join the PIE market, with a longer perspective than just one year engagements.

Mandatory joint audit is required by law in all companies required to publish consolidated financial statements (PIE or non-PIE). In some financial institutions and companies, mandatory joint audit applies, even if no consolidated financial statements publications are required. 52% of PIEs publish consolidated financial statements and therefore have more than one auditor.

A number of potential benefits from the joint audit regime can be identified:

- ❖ In terms of market concentration, joint audit is one of the factors that has opening up of the audit market. In 2018, 331 different audit firms were involved in the audit of PIEs in France. Recent figures show that 55%⁷ of the PIE engagements are held by the “Big Four”. From an audit fees point of view, 28% of the PIE audit market is outside the “Big Four”, mainly including Mazars.

⁷ For a joint audited entity, each joint auditor holds one engagement

Box 1.3: Joint audit in South Africa

In South Africa, the Prudential Authority encourages large banking groups to implement joint audit. Broader requirements to implement joint audit are currently under consideration.

The South African joint audit leads to a joint opinion on the financial statements. Joint auditors act together as a “college”: they together perform a joint examination of the financial statements, sign a single audit report and communicate jointly with the entity. They are jointly responsible for the opinion issued.

There are no rules in place regarding the allocation of work amongst auditors. However, the Independent Regulatory Board for Auditors (IRBA) is in the process of issuing guidance applicable to auditors. It will encourage audit committees to ensure that there is a balanced approach in sharing of audit work.

Every audit firm can be a joint auditor. There are no specific requirements for the composition of the pair of auditors, nor a requirement to include at least one non-systemic audit firm.

Joint audit is not mandatory and therefore not required across all sectors. However, the Prudential Authority makes it a condition for the large banking groups to have joint auditors. An extension to large insurance groups is under consideration. In any other instance, joint auditors are appointed on a voluntary basis.

C. The introduction of new requirements for joint audit is under consideration in several jurisdictions.

The suggestion for introducing mandatory joint audit has for instance been raised in 2020 in the Netherlands as one of the possible actions to prevent market vulnerability, though it is still under discussion and is not clear whether these recommendations will be considered for implementation.

On the other hand, some jurisdictions removed joint audit requirements that previously existed. As an example, a banking regulator decided in 1992 to remove the joint audit requirement that until then existed for federally regulated banks. Reasons cited to abolish this requirement at the time included harmonization with audit requirements for other financial institutions, and risks associated with the model.

Various reasons are provided by those requiring, allowing or considering joint audit. Some regulators indicate the increased impartiality vis-à-vis the audited entity due to the college of auditors, increases in the challenging approach of the auditors, due to mandatory cross review (“two sets of eyes” approach), an increase in technical competence of audit firms by sharing experience, and increased continuity of the audit when one of the auditors is replaced, and increased number and size of non-“Big Four” participants in the audit market.

In some cases, a specific obligation to appoint at least one joint auditor that is not among the “Big Four” was considered.

In June 2020, the European Parliament called on the Commission to propose further measures to address what it referred to as the quasi monopoly of the “Big Four” firms auditing the largest listed companies, such as the setting up of mandatory joint audit to enable firms outside the “Big Four” ones to develop the capacity needed to audit the biggest companies.⁸ This follows a 2010 European Commission proposal and a 2019 French recommendation⁹ that at least one of the two joint auditors should be a challenger audit firm.¹⁰ In the UK, the concept of shared audits, whereby the component auditor is from a network other than the group auditor, is under consideration. See Box 1.4.

Box 1.4: The UK proposals on joint audit

Joint audits including two audit firms are possible but rarely used in the United Kingdom. Yet, the Competition and Market Authority (CMA) has recommended in April 2019 to implement a full joint audit regime. According to the CMA, mandatory joint audit would increase choice in the market and thereby drive up audit quality. Indeed, the CMA’s view is that in a regulatory regime that ensures that competition is focused on what matters to shareholders (*i.e.* audit quality), competition should be an effective mechanism for driving audit quality. All things being equal, the more choice that audit committees have in selecting their auditor, the stronger competition will be. In turn, the CMA expects this to drive better market outcomes, including higher audit quality, under the right regulatory framework. Also, if there were stronger choice and competition, firms would face a much greater risk of losing market share if their audit quality was poor. But it is not clear that firms over which concerns have been raised about audit quality have in fact been losing market share. The CMA cites the example of KPMG; its market share remained fairly constant at around 20% of FTSE 350 audit fees over the period 2011 to 2017 and increased to 25% in 2018 while its FRC audit quality review (AQR) results for FTSE 350 audits were less good than the other Big Four firms in 2015/16 to 2017/18. All together, the CMA believes that through the introduction of mandatory joint audits, the resilience of and competition in the audit market will improve, leading ultimately to better audit quality.

The proposals are that joint audit would require two audit firms to sign the audit report of an audited entity. The two audit firms would divide the fieldwork between them. Audit committees would ensure that the work of each of the two joint auditors is substantial and relatively equal, starting with each audit firm receiving at least 30% of the audit fees. Responsibility for the audit opinion would rest with both auditors. The proposal states that at least one joint auditor should be a non-Big Four firm. Any audited entity would be exempted from joint audit if it appoints a non-Big Four firm as its sole auditor. Audit committees would be free to arrange the respective timings of each joint auditor’s appointment.

The CMA envisaged that joint audit would be a legal requirement for most main listed index (FTSE350) companies. The exceptions would include the largest and most complex companies, companies with single-entity accounts such as investment trusts and companies that do not prepare consolidated accounts. An exemption could be allowed when all firms outside the Big Four are unable to provide a service.

⁸ European Parliament resolution on competition policy – Annual report 2019, European Parliament, June 2020

⁹ Report on audit market monitoring, Haut Conseil du Commissariat aux Comptes, June 2019

¹⁰ Green paper – Audit Policy: Lessons from the crisis, European Commission, October 2010

According to the CMA, the introduction of joint audit in the UK should be gradual. Companies should make the transition when their next tenders arise. The regulator should be empowered to increase or decrease the coverage of the joint audit over time. It should remain in place until that competition has improved enough.

The Financial Reporting Council (FRC) and Sir Donald Brydon’s recommendations for changes to the scope of audit have voiced some concerns about the CMA joint audit proposal. The FRC has expressed its preference for mandatory managed “shared audit”. The latter would ensure the smaller firms to pick up substantial work: they would audit a subsidiary, while the larger audit firm does the group audit. Rules would provide the smaller firm to be properly integrated in the whole audit, report to the audit committee and have exposure at the group level. The rules might also include rotation around the group structure and a guaranteed minimum percentage of fees for the smaller firms.

Having specific requirements on the composition of the pair of joint auditors could influence the selection of non-“Big Four” auditors, especially where the number of market participants is limited. Indeed, selecting a pair of auditors within the “Big Four” would lead to a challenging approach on the audit, but would not have a deconcentrating effect on the market. The impact of joint audit in lowering market concentration can be enhanced by additional measures that would avoid the situation that the current main players continue to be primarily selected by entities, in the constitution of the pairs of auditors.

To that end, the UK CMA suggested that the law could impose that at least one joint auditor should be a non-Big Four firm. Any company that would fall within the scope of joint audit could be exempted if it appoints a non-Big Four firm as its sole auditor. The European Commission proposed in 2010 that at least one of the two joint auditors should be a non-systemic audit firm.¹¹

In France, there are no such specific obligations, and it appears in practice that appointing a pair of “Big Four” auditors in a joint audit situation is not the scenario preferred by the audited entities. However, the French regulator recommended in 2019 to further encourage this route, for large groups of companies and subsidiaries with a large international coverage.¹²

Market share cap

A regulation limiting auditors to a maximum “market share cap” or limiting the access to the audit market for organizations that exceed a certain size of the market, could be a way to reduce concentration. The UK CMA suggested in April 2019 that it would not exclude share caps as a possible solution in future, depending on how the market develops, but concluded that the best route for early action lies with joint audit. See Box 1.5.

¹¹ Green paper – Audit Policy: Lessons from the Crisis, European Commission, October 2010

¹² Report on audit market monitoring, Haut Conseil du Commissariat aux Comptes, June 2019

Box 1.5: Market capping in the UK

According to the UK Competition and Markets Authority (CMA), a market share cap remedy would break down the barriers to non-Big Four firms and therefore increase the market share of challenger firms. Yet, the CMA states that a cap carries a risk to short and medium-term audit quality, through reduced choice and competition. It might also require challenger firms to act as sole auditors for companies which are more complex than their current clients. By contrast, joint audit provides for a gradual scaling up of a challenger firm working alongside an experienced “Big Four” firm, according to the CMA. A cap might also cause ‘cherry-picking’ of audit clients by the “Big Four”; the “Big Four” could choose to shed their highest-risk or lowest-profit clients and therefore undermine the challenger firms’ positions.

However, the CMA would not totally exclude share caps as a possible solution in the future, depending on how the market develops. It concluded, on balance, that at this point in time the best route nevertheless lies with joint audit. The latter offers many of the potential benefits of a share cap, without many of the risks. It serves the purpose of breaking down the barriers to non-Big Four firms, while maintaining maximum choice for audit committees.

The FRC sees market share capping as a reserve measure, as part of its preferred option for mandatory managed shared audit. Market share caps could be used if challenger firms do not have, despite mandatory managed shared audit, a meaningfully higher proportion of FTSE350 audits within an agreed period of time. However, the regulator would need powers to design and implement any market share cap(s) in such a way that address the potential problems with such a measure, including powers to avoid firms resigning from reputationally risky or low margin engagements.

Market capping can also be more widely understood than prohibiting the networks to apply for new audit engagements if their market share is deemed too high already. It can be envisaged not only as a cap based on the share of an audit firm in the audit market, but also as a cap regarding some other activities. Services would be prohibited by nature without introducing a formal market cap. For instance, in Australia, one “Big Four” firm suggested that consideration could be given to capping non-audit services (excluding other assurance and audit-related services) for the biggest listed companies. Capping would involve allowing permitted non-audit services to be provided by the statutory auditor up to a set percentage of the fees paid for the statutory audit. Such capping on provision of non-audit services could also be seen as a way to open the market of audited related services to others firms outside the major players.

Other measures

Apart from joint audit used in some countries, regulatory frameworks include elements which facilitate access to the PIE audit market to a wider range of auditors. A regulation in the European Union protects audit firms which have less than a 15% market share from being eliminated from tendering in the PIE market. The goal of the legislation is to ensure that the PIE audit sector remains open to all registered statutory auditors. No company is entitled to issue audit tenders restricting eligibility to the main players in the market, based on a given market share held (or “Big Four” firms in particular).

Specific powers in case of audit firm failure

Although regulators care about the impact of audit firm failure, only a few jurisdictions have introduced legislation allowing regulatory powers to address urgent situations and maintain competition. In case of the failure of one big player, it may not be replaced in a sufficiently timely manner, which would lead to an additional increase of the market concentration. That is why, facing this issue, some jurisdictions may envisage a temporary solution with specific powers devoted to regulators, to address urgent situations and maintain the competition.

An audit market resilience recommendation increasing the regulator's powers, is currently being considered by the UK Government. See Box 1.6 on developments in the UK.

Box 1.6: Audit market resilience recommendation by CMA UK

In the UK the CMA has made an audit market resilience recommendation, which is currently being considered by the UK Government. The UK Government will also cover this in its proposals for audit reform which are expected to be published in Autumn 2020.

Specifically the CMA recommended that the regulator should have the powers to:

- ❖ Obtain the information it needs to monitor the health of the Big Four's audit practices to act as an early warning, including requiring audit committees to inform it of upcoming tenders ; and
- ❖ Intervene as necessary.

The aim of the CMA recommendation is to preserve choice if a Big Four firm was in distress or approaching failure and ensure that as many as possible of the audit clients of a distressed Big Four firm were transferred to a new firm, a challenger firm, or remain within the same firm while a turnaround was implemented. If accepted by the UK Government and implemented, this recommendation would build on the FRC's existing audit monitoring work which includes monitoring the biggest firms' contingency planning, drawing on information provided by the firms on a voluntary basis.

Annex – Market Concentration and joint audit literature

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