

*Shared and joint audits:
are two auditors better than one?*





Audit is currently undergoing an unprecedented level of public scrutiny. The expectations of investors and other stakeholders – including employees, customers, suppliers and pension-holders – have increased in recent years, and the purpose, scope and practice of audit need to keep pace.

ICAEW's Audit and Assurance Faculty is developing a series of thought leadership essays that consider issues directly or indirectly relevant to the international debate about the future of audit. This series is intended to help directors, politicians and policymakers understand the key issues, and it will, among other things, help to inform the development and implementation of recommendations in the UK regarding audit, its regulation and the market for audit services.

The faculty has also published two background papers to support these thought leadership essays:

- ***Financial reporting: who does what?*** is intended to help readers understand who is involved in the preparation of financial statements, how they are involved, and the role of auditors in challenging those responsible.
- ***What auditors do: the scope of audit*** explains what auditors do, why audits are necessary and their current limitations, and what auditors do and don't audit.

These papers are available to all at [icaew.com/futureofaudit](https://www.icaew.com/futureofaudit), and further papers will be issued in the coming months. If you have views on any of them, we would very much like to hear from you. Please email your comments to Nigel.Sleigh-Johnson@icaew.com

ICAEW is engaged with the various inquiries into audit in the UK, and is responding to the key consultations. Our thought leadership essays, including this one, will be used to highlight and develop the key issues arising from these inquiries.

Contents

INTRODUCTION	2
WHAT ARE SHARED AUDITS?	3
What experience is there of shared audits?	3
WHAT ARE JOINT AUDITS?	4
What experience is there of joint audits?	5
WHAT ARE THE BIG ISSUES WITH SHARED AND JOINT AUDITS?	6
What might shared or joint audits mean for audit costs and auditor liability?	6
How do conflicts of interest affect the choice of auditors?	6
Would shared or joint audits improve audit quality?	7
Auditing standards and guidance	7
Making a success of shared or joint audits	8
MOVING FORWARD	9

Introduction

Auditing groups of companies used to involve several different firms of auditors, particularly when those groups had international operations. Today, the global reach of the largest audit firms means that a single audit firm can, and usually does, perform the entire group audit - the audit of the consolidated group accounts as well as the audit of all of the components in the group, wherever they are in the world.

There are alternatives:

- In shared audits, one firm is appointed to perform the audit of the group accounts and, usually, some of the components, while another firm, or firms, audits the other components, representing a significant share of the total group.
- In joint audits, two or more firms are appointed to take joint responsibility for the entire group audit.

But shared and joint audits are both rarer than they were. Shared and joint audits have declined in popularity as audit firms have developed their international networks and made it easier for businesses to appoint a single audit firm globally. Where shared audits are still performed, they are often the result of auditor rotation, independence or other regulatory requirements.

The audit market for larger listed companies in many jurisdictions, including the UK, is now dominated by four audit firms and their international affiliates: Deloitte, PwC, EY and KPMG (the 'Big Four'). These firms are significantly larger than 'challenger' firms such as BDO, RSM, Grant Thornton, Crowe, Nexia, Baker Tilly and Mazars. Governments and regulators in a number of jurisdictions are considering whether to intervene in this market in an attempt to increase audit quality, competition and choice. Mandating shared or joint audits might be one way of achieving this. In the UK, for example, the Competition and Markets Authority (CMA) has proposed that the 350 largest listed companies either appoint joint auditors, with one being a challenger firm, or appoint a challenger firm as their sole auditor. The objective is to enable challenger firms to expand their capabilities and scale to compete more effectively with Big Four firms.

The evidence that exists is far from compelling in terms of the impact of a second audit firm on audit quality or cost. There is also, inevitably, uncertainty about how successful any reforms might be in increasing competition and choice. But as a general principle, two professional opinions are often considered better than one and seeking a second opinion is seen as a good thing. This is at the heart of the joint audit debate for some, to whom it seems obvious that two audit firms issuing a joint audit opinion must be better than one. For others, joint or shared audits are simply one way of increasing competition and choice in the audit market which, of itself, should improve audit quality.

However, some audit firms and investors remain unconvinced that the risks and long-term costs associated with joint audits in particular can be justified. They argue that while shared and joint audits are often referred to as if they were simple alternatives to each other, operationally they are very different, and they have different profiles in terms of risks and rewards for companies, audit firms and investors.

Both shared or joint audits would take time to implement. They would need to be phased in as existing audits come up for tender, allowing challenger firms time to recruit new staff, adapt their audit processes, develop and implement training programs and to enhance their quality control and risk management systems. Audit fees may well be higher, particularly for joint audits. Regulators would need to monitor progress to ensure that challenger firms were progressing as expected.

Shared or joint audits are not a quick fix and would require sustained investment of regulatory time and effort over a number of years, and substantial investment on the part of challenger firms. Investors and audit committees would need to adapt to different ways of working with auditors and audit firms will not make the necessary investment if they believe that there is any real risk that the reforms will be reversed, as has happened in a number of jurisdictions. It may take at least 10 years to see full benefits from the reforms and if that proves too long, other alternatives need to be considered.

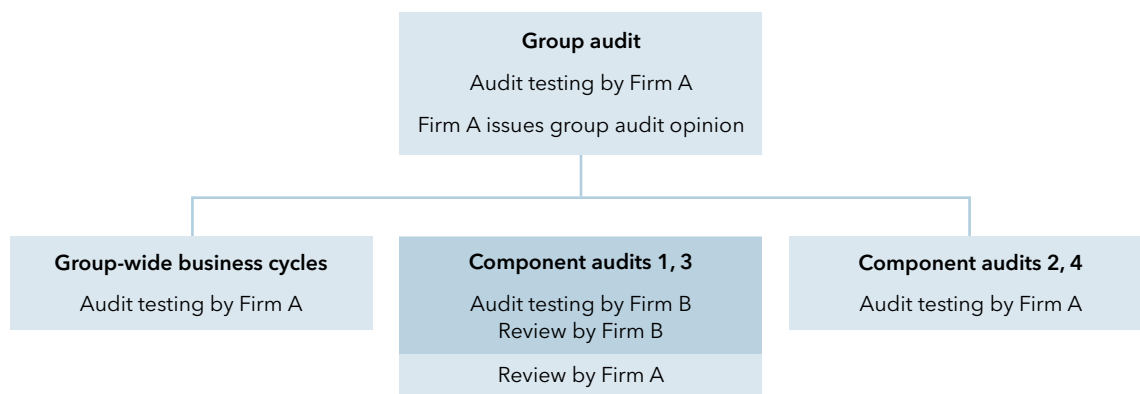
What are shared audits?

Shared audits involve one audit firm (the group auditor) providing an audit opinion (the group audit opinion) on the consolidated group accounts (the group accounts), with another firm (or firms) responsible for the audit of one or more material components of the business. Component audits can be allocated by company, by division (ie, by business line or geography) or, less commonly, by business cycle - one firm testing taxes and financial instruments, the other testing IT systems and inventory management, for example.

In a shared audit, the group auditor has full responsibility for the group audit opinion, despite the fact that some of the component audits are performed by another firm. The other firm is only responsible for the components it audits, and any other audit testing it may perform at the request of the group auditor.

Figure I illustrates how a shared audit might work. Firm A audits the group accounts and some of the components. Firm B audits other components. In this example, Firm A is responsible for the audit work on group-wide business cycles. Firm B may need to review some of Firm A's audit work on group-wide business cycles for the purpose of any audit opinions it issues on subsidiary company accounts.

Figure I - Simplified illustration of a shared audit



Other permutations are possible, particularly in larger or more complex audits in which, for example, some component audits might be joint or shared audits.

WHAT EXPERIENCE IS THERE OF SHARED AUDITS?

Shared audits used to be common for many international businesses but, over time, larger listed companies have migrated to being audited by one audit firm. In the UK, 97% of the 350 largest listed companies are audited by Big Four firms. This is primarily a consequence of the development of audit firms' international networks and increasing integration within international businesses, it being simpler if just one firm tests group-wide systems, processes and controls.

Increasingly, where shared audits still exist, they are required because of differences in auditor rotation requirements around the world. For example, a South African component might be required to rotate its auditors on a different basis to the rotation requirements applying to the group auditors located in Europe, meaning that a different firm would have to be appointed. Joint venture investors still sometimes prefer a second firm to be involved, and other auditors might be also appointed where a component has a very distinct set of systems and corporate governance arrangements.

Another factor in the reduction of shared audits has been regulatory and investor pressure to select a single audit firm in response to past audit failures, such as that of the Parmalat fraud in 2003, although subsequent audit failures suggest that similar issues also arise in audits by a single audit firm.

What are joint audits?

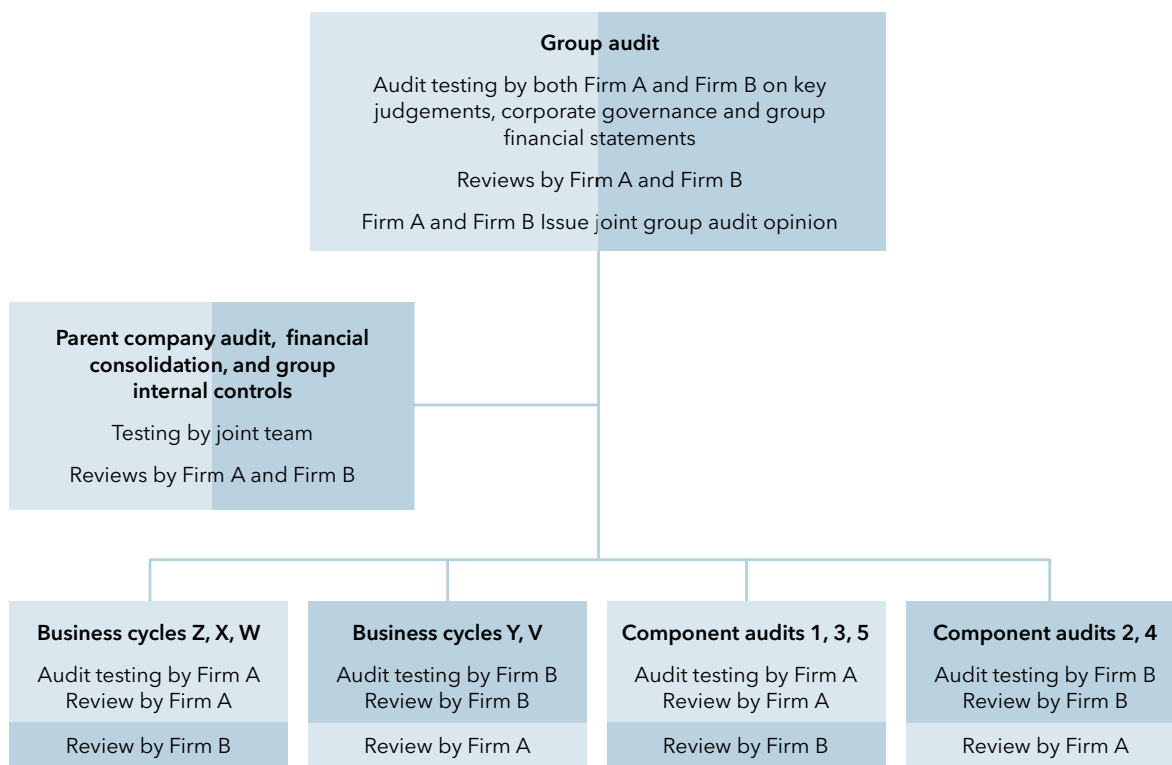
Joint audits involve the engagement of two audit firms to jointly conduct and take full responsibility for the entire group audit, ie, the audit of the group accounts and all of the components. In practice, component audits and the testing of business cycles and common IT systems are allocated between the firms, and they review each other's work.

Both audit firms need to reach their own audit opinion on the group accounts but they normally issue a single group audit opinion. They do not assume that the other firm's work is satisfactory; each firm reviews the work of the other. They often perform their own testing in areas audited by the other audit firm, on component balances that are individually material at a group level, for example. This is in addition to the review and quality control procedures each firm performs on its own work.

Joint audits require both auditors to agree on the group audit opinion. Audit reports can now run to several pages covering the key audit matters encountered and observations arising and requires a high level of co-operation between the two firms concerned. In the highly unlikely event that the firms disagree, the group audit report would include each auditor's opinion and the reasons for the disagreement.

Figure II illustrates how a joint audit might work. Firms A and B audit the group and parent company accounts, financial consolidation, group internal controls, and some of the components. Firms A and B are responsible for the audit work on group-wide business cycles. Each firm needs to review all the other's audit work.

Figure II - Simplified illustration of a joint audit



Again, other permutations are possible and some component audits might be joint or shared audits.

WHAT EXPERIENCE IS THERE OF JOINT AUDITS?

A small number of jurisdictions currently mandate joint audits and in others they are performed voluntarily. They are sometimes mandated or are common practice in certain sectors, such as banking, and sometimes the size of the company determines whether they are performed.

In France, joint audits are mandated for larger listed companies, banks and political parties. In Belgium, and South Africa and a handful of other African jurisdictions they are mandated for companies in the financial services sector. Joint audits were once common practice for financial institutions in the UK. Where mandatory requirements for joint audits have been removed, such as in Denmark in 2005, most listed companies have subsequently moved to a single firm for their audits, although a few have chosen to maintain their joint audit voluntarily.

Mazars, the largest challenger firm in France, believes that the mandatory requirements there have helped to ensure greater representation of challenger firms in the audits of the largest companies. Mazars and 12 other non-Big Four firms are involved in the audit of the top 100 French listed companies, compared with only one involved in the FTSE-100 in the UK. However, France only mandates joint audits, it does not mandate the involvement of a challenger firm.

As a result, a significant proportion of the joint audits of the largest listed companies in France involve either two Big Four firms or one Big Four firm and Mazars - arguably a 'Big Five' regime. While this may be partly the result of acquisitions of former challenger firms by Big Four firms, the CMA proposals for joint audits in the UK seek to address this possibility by prohibiting two Big Four firms being appointed as joint auditors together.

What are the big issues with shared and joint audits?

WHAT MIGHT SHARED OR JOINT AUDITS MEAN FOR AUDIT COSTS AND AUDITOR LIABILITY?

Many larger firms believe that the additional costs associated with shared and joint audits are likely to be significant for the entities audited and for audit firms. They believe that the additional cost of joint audits would be greater than they would be for shared audits, because of the duplication of work involved. Both firms need to reach their own conclusion on the group audit, and each must perform a certain amount of testing in the areas the other firm has audited. Each firm's work on component audits and group-wide business cycles needs to be reviewed twice, once by each firm.

Conclusions drawn from academic and other analyses on the effect of joint audits on audit fees have been mixed, ranging from no significant differences to increases in excess of 25%. It is important to remember that audit fees are not the only cost to be considered, because more management time and resources may be needed to support the audit process if two firms are involved.

In the UK, the CMA has suggested that the additional costs incurred by listed companies could be offset by a lower cost of capital, because investors would have higher levels of confidence in the audited financial statements.

Challenger firms taking on shared or joint audit engagements should of course benefit from the additional fees, the experience and expertise they develop and the opportunity to grow. However, these opportunities come with significant additional risks to those firms. For shared audits this would particularly be the case where components of listed companies are larger than the businesses a challenger firm currently audits. There may also be indirect risks, such as the failure of a component leading to the collapse of a much larger group. But audit firm exposure for joint audits is even greater.

In many jurisdictions, including the UK, joint auditors have joint and several liability, which means that each firm is liable for the acts and omissions of the other. If one firm is unable to pay its share of any damages awarded as a result of a negligently performed audit, the other firm would be liable for the full amount. Governments seem unlikely to change these long-standing arrangements, which are intended to protect investors.

These are not insignificant issues. Challenger firms may need to consider self-insurance in a similar manner to larger firms, to cover the higher level of risk associated with the audit of considerably larger and more complex businesses, as well as the increased risk associated with joint and several liability.

For the very largest and most complex audits, the CMA in the UK has suggested alternatives to joint audits. They include reviews of those audits by another firm. Even this is not risk-free for the other firm. Such a firm could still be exposed to regulatory sanctions and litigation if it failed to detect defects in the audits it reviewed.

Ultimately, each challenger firm will of course decide the level of risk that it is willing to assume in return for the fees that might be on offer, and the opportunities it has to develop and grow.

HOW DO CONFLICTS OF INTEREST AFFECT THE CHOICE OF AUDITORS?

Big Four and challenger firms all provide accounting, tax, legal and consultancy services that prevent them from acting as auditor at the same time. Sometimes, both in the UK and elsewhere, there may be in effect only one alternative among the Big Four firms if an audit committee is dissatisfied with its current auditor.

It would therefore be important to ensure that a sufficient number of challenger firms participated in the market. For that to happen, there would need to be an incentive for challenger firms to give up any non-audit services they provide to companies they wish to audit. While the issue is likely to be more acute in

the case of joint audits, both shared and joint audits would reduce choice in the market for both audit and non-audit services. This is because two firms would be prevented from tendering rather than one. It therefore also seems possible that temporary regulatory waivers might be needed in the event of audit firm mergers or acquisitions.

WOULD SHARED OR JOINT AUDITS IMPROVE AUDIT QUALITY?

On the face of it, the involvement of two independent audit firms rather than one should improve audit quality if implemented effectively. For joint audits in particular, the audit process should benefit from different perspectives, and greater levels of review and other quality control processes should increase confidence in the group audit opinion. Two auditors should also be in a stronger position to challenge management than one firm alone.

However, measuring the effect of shared or joint audits on audit quality has proved challenging. A limited number of shared and joint audits are performed. There are also difficulties in differentiating between the effects of the involvement of another audit firm, and other factors such as the business environment, legal systems, regulator behaviour and corporate governance requirements. And any benefits arising from the involvement of another audit firm may be offset by other factors, such as difficulties in interactions between the two firms.

The research evidence available on joint audits is far from compelling in terms of providing positive support for the impact of joint audits on audit quality.¹ On the other hand, there is no compelling evidence that suggests any significant deterioration in audit quality where joint audits have been replaced with audits by a single firm.

Co-operation is required in both shared and joint audits, particularly joint audits, and may require regulatory reinforcement. In a joint audit, both firms would need direct access to audit committees, so that the performance of one audit firm would not be assessed through the eyes of the other.

AUDITING STANDARDS AND GUIDANCE

Shared audits are covered by International Standards on Auditing (ISAs), with ISA 600 on group audits setting out requirements for the group auditor to follow, irrespective of whether component auditors are from the same or a different firm.

Joint audits are effectively excluded from the scope of ISA 600. At the time of writing, the International Auditing and Assurance Standards Board (IAASB) was updating and revising ISA 600 on group audits and there were no plans to cover joint audits. There is therefore no international equivalent of the French auditing standard on joint audits, NEP-100.²

NEP-100 sets out high-level requirements for balance in the allocation of work, for each auditor to make an assessment of audit risks and the control environment, and to perform critical reviews of the work performed by the other firm. It also sets out a joint approach to communication with the audited entity.

It seems likely that any authority choosing to mandate joint audits would need to consider additional auditor guidance. Any such guidance might well go further than NEP-100 in providing more specific criteria on how to determine the allocation of component audits and business cycles between the two firms, and on communications with audit committees. It might also provide guidance on when the challenger firm should take a more active role in coming to a joint position on a particular accounting treatment, or in testing critical business cycles (rather than simply reviewing the work of the other auditor), as well as on the need for supplementary testing for larger components.

¹ Dr Javed Siddiqui, Alliance Manchester Business School, University of Manchester, Are four eyes better than two? An examination of recent empirical evidence on the impact of joint audits. <https://bit.ly/2lxEOWK>

² Norme d'exercice professionnelle (NEP-100) 'Audit des comptes réalisés par plusieurs commissaires aux comptes'. <https://bit.ly/2lWrDP6>

Domination by one audit firm would limit the effectiveness of any reform, and legislation, regulation or guidance would need to cover the percentage of the audit performed by the challenger firm. The CMA has proposed a minimum 30% fee threshold in its recommendation for joint audits in the UK.

MAKING A SUCCESS OF SHARED OR JOINT AUDITS

At present, many challenger firms in the UK do not participate in larger audits due to the cost of tendering, because their chance to succeed over Big Four firms has historically been low, and because they do not have the extensive networks in the corporate world that are perceived, rightly or wrongly, to work to the advantage of Big Four firms.

Challenger firms would need to gain the confidence of those investors who have put pressure on listed companies to choose Big Four firms, despite the fact that both Big Four and challenger firms have experienced audit failures.

Everyone involved would need to consider how to overcome 'Catch-22' situations in which challenger firms are unable to demonstrate that they have the experience to bid for larger engagements without first having gained that experience. Shared rather than joint audits are perhaps one way of achieving that, particularly for the very largest listed companies with complex operations requiring specialist skills and a global reach that challenger firms do not have.

Reforming the audit market will take time, perhaps more time than some will find acceptable. Challenger firms seem unlikely to be ready to take on a very large number of new audit engagements at short notice. Implementation would need to be phased over time as existing audits come up for tender. In Europe this is every 10 years for most listed companies although some companies might choose to appoint a second audit firm earlier than required, depending partly on the readiness of challenger firms to accept the work.

Moving forward

If shared or joint audits were mandated, audit committees would need to prepare well in advance of their next audit tender. They would need to identify able and willing challenger firms, and address any conflicts arising from the provision of non-audit services. For joint audits, they would also need to decide whether or not to rotate both firms at the same time.

Audit firms too would need to plan. Joint and shared audits would require more planning and entail additional risk for Big Four firms as well as challenger firms which would need to be balanced with additional fees. Challenger firms would need to consider to what extent they were willing to invest in tendering for audits and in gearing up for first year audits if they were successful. Preparing for shared audits would probably be less disruptive for both companies and auditors than preparing for joint audits.

The existing business and pricing models used by audit firms might not be appropriate in the face of an altogether greater risk profile, particularly for joint audits. Audit regulators would need to prepare for the risk that, in some cases at least, companies would be unable to appoint a challenger firm with the skills or scale necessary to serve as joint auditors. While regulators might be keen to encourage as many joint auditor appointments as possible, and would seek to limit the number of companies exempted, they would need to develop alternative arrangements, such as the peer reviews proposed in the UK.

Government and audit regulators would need to consider support for challenger firms and listed companies if reforms were introduced. They would also need to establish a process for monitoring shared or joint audits to determine whether competition and choice did in fact increase over time, and whether there was a positive effect on audit quality.

Government and audit regulators would also need to consider whether, in the medium to long term, they envisaged the possibility that as a result of successful reforms, there would be sufficient choice in the market to do away with compulsion and allow companies to revert to appointing a single firm of auditors if they wish. If they thought this an unlikely outcome, they might need to re-consider the real purpose of the proposed reforms.

Governments and audit regulators in a number of major economies are considering mandating shared or joint audits with a view to improving audit quality and increasing competition and choice. In the UK, government and audit regulators are considering the CMA's proposal for joint audits, with strong parliamentary support. South Africa has recently imposed a requirement for large banks to appoint joint auditors and is considering extending the requirements to larger listed companies.

If shared or joint audits are newly mandated in the UK or any other jurisdiction, everyone involved will need to take a long-term view of the significant changes required. Only by doing so, we suggest, will it be possible for two auditors to be better than one. If a long term approach is not achievable, other means of improving audit quality and increasing competition and choice will need to be considered.

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The faculty is producing a series of succinct, high-level thought leadership essays on themes that are relevant to the debate on the future of audit. They are designed to inform the various inquiries relevant to audit and regulation, and to improve the understanding of these by boards, investors, politicians, policymakers and others. These are available at [icaew.com/futureofaudit](https://www.icaew.com/futureofaudit)

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