

# **Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience**

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## **Abstract**

This article presents original results on the effects of the justification of assessments (JOA), which are mandatory in France since 2003. These JOA are similar to Key Audit Matters that might be disclosed by auditors around the world in a near future, in order to enhance the informative value of auditors' reports. Our results show that the disclosure of additional information by French auditors has very limited effects. On the one hand, the financial market does not react significantly to these JOA. On the other hand, the quality of the audit (proxied by a measure of earnings management), the cost of the audit (proxied by audit fees) and the efficiency of the audit (proxied by the audit report lag) are not significantly affected by the JOA. Finally, our results confirm the idea that the disclosure of additional information by the auditors rather has a symbolic value than an informative value. However, it is likely that our results might be different in other institutional contexts, especially in contexts where the auditors' liability is not similar, or in contexts where auditors not only disclose clean opinions. Thus, our results allow enriching the current international debate on the introduction of Key Audit Matters.

## **Keywords**

Key audit matters - France - Market reaction - Audit quality - Audit lag - Audit fees.

# **Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience**

## **INTRODUCTION**

The International Auditing and Assurance Standards Board (IAASB 2013) and the Public Company Accounting Oversight Board (PCAOB 2013) have recently proposed for public comment new auditing standards that would require auditors to communicate in the audit report “Key Audit Matters” (KAM) specific to the audit. These changes in audit reporting aimed at reducing the information gap – differences between the information users desire and what is available to them through the entity’s disclosures and the auditor’s report (IAASB 2011).

There is no evidence yet on whether a requirement for auditors to communicate additional information will increase the communicative value of the audit report and reduce the information asymmetry that exists between company management and investors. Indeed, there are concerns about these communications. Over time, they may become boilerplate (IAASB 2012a; Footprint Consultants 2011), liability concerns may result in auditors reporting on as few matters as possible or providing a lengthy list of redundant disclosures (IAASB 2012a), the disclosures may not be easily understandable because of the use of technical language (Footprint Consultants 2011), they may result in excessive other reporting that might cause the auditor’s report to be ambiguous (IAASB 2011), and in additional cost with questionable benefit (IAASB 2012a).

The idea of auditor disclosure of key audit matters is not completely new. In France, since 2003, auditors must provide commentaries, called “Justification of Assessments” (JOA), in their report. JOA are very similar to key audit matters in that they must “enable the user of the report to obtain a better understanding of the reasons behind the statutory auditors’ opinion on the financial statements” (Haut Conseil des Commissaires aux Comptes 2006). As for the key audit matters they are disclosed in separate section after the audit report and when applicable, refer to the relevant financial statement accounts and disclosures that relate to the disclosed matter.

This study aims to assess some of the benefits and costs of such JOA. In order to do so, we create a database of 953 annual reports of large French listed companies, for the period 2000-2011. In a first step, we study the reaction of the French financial market at the announcement of the JOAs. Our results show that the market reaction is not more different since the disclosure of the JOAs. Therefore, we conclude that the information content of such reports is low for investors.

In a second step, to better understand the reaction of the financial market, we focus on three aspects of the audit: its quality, its cost and its efficiency. First, the quality of the audit, which is proxied by a measure of earnings management, is not affected by the introduction of the JOA in France. In other words, it seems that the auditor does not provide additional efforts other than those of writing one or two additional pages. Second, the cost of the audit, proxied by audit fees, is not significantly modified by the JOA. Therefore, the quality/cost ratio of audit services is not really modified by the introduction of JOA in France. Third, the efficiency of the audit, proxied by the audit report lag, is however slightly affected by the introduction of the JOA. Overall, these results on the three dimensions of the audit (quality, efficiency and cost) help to understand the absence of a reaction of the French financial market to the JOAs.

These results contribute to enrich the academic literature. We confirm that additional disclosures by auditors have no informative content (no reaction of the financial market) and do not affect the key characteristics of the audit (quality, efficiency, cost). Therefore, we confirm that the content of an audit report, even more detailed, remains essentially symbolic (Church et al. 2008; Mock et al. 2013). Besides, our results allow enriching the current international debates on the introduction of KAM. Because we find that more detailed audit reports are of limited value in France, we consider that it is likely that the effect of the introduction of KAM will be extremely limited in similar countries. However, it is possible that in other institutional contexts the introduction of KAM may have more pronounced effects. It is notably the case in countries where minority shareholders have stronger rights to sue auditors, or in countries where auditors do not systematically issue clean opinions. Therefore, it may be appropriate to adjust the new constraints (KAM disclosures) based on the institutional context.

The remainder of this paper is organized as follows. In a second section, we present the institutional contexts relating to the establishment of KAM disclosure, and of JOA in France. In the third section, we discuss the costs and benefits that can be expected from the introduction of the JOA in France. The fourth section is devoted to our methodology. The fifth section presents and discusses our results. A final section summarizes our results and concludes.

## INSTITUTIONAL CONTEXT

The idea that auditors should disclose more detailed reports spreads widely since the 2008 financial crisis. The IAASB, the PCAOB and the European Commission are particularly favorable to the disclosure of Key Audit Matters (or Critical Audit Matters) by auditors. A few years ago, such a debate existed in France, where auditors are required to justify their assessments since 2003.

### **The proposal of introduction of Key Audit Matters (KAM)**

Following the recent financial crisis, many economic and political actors around the world have questioned the role of auditors. In particular, they criticize the fact that the audit report is highly standardized and its information content is low. For example, in the invitation to comment, Professor Arnold Schilder states in his IAASB chairman's statement:

*“What does today’s auditor’s report on financial statements deliver? It is generally a short, standardized report that describes the financial statements subject to audit, the audit itself, and the respective responsibilities of management and the auditor. (-) The global financial crisis also has spurred users, in particular institutional investors and financial analysts, to want to know more about individual audits and to gain further insights into the audited entity and its financial statements. And while the auditor’s opinion is valued, many perceive that the auditor’s report could be more informative. Change, therefore, is essential”.*

To have a clear idea about the fundamental changes in the audit reports that should be implemented, the IAASB launched consultation papers in May 2011 and June 2012, that were followed, on July 2013, by an exposure draft *“Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (the proposed ISAs)”*.<sup>1</sup> The

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<sup>1</sup> The timetable is the following: Comments are requested by November 22, 2013; The approval of final revised auditing standards is June 2014; The proposed effective date is December 2016.

objective is to increase the communicative value of auditor's report to users. To achieve this objective, the proposed ISAs require, among other, that auditors of financial statements of listed entities communicate in a separate section of their report Key Audit Matters (KAM).

KAMs are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. KAM are selected from matters communicated with those charged with governance. In determining which of the matters communicated to those charged with governance are KAM, the auditor should take into account areas of significant auditor attention in performing the audit, including: (a) Areas identified as significant risks or involving significant auditor judgment; (b) Areas in which the auditor encountered significant difficulty during the audit, including with respect to obtaining sufficient appropriate audit evidence; (c) Circumstances that required significant modification of the auditor's planned approach to the audit, including as a result of the identification of a significant deficiency in internal control.

A quick look at the responses to this ED highlights that the community of users of financial statements (financial analysts and investors) are generally satisfied by this proposal. For example, the CFA Institute<sup>2</sup> argues that: *“Through increased transparency, a revised standard auditor's report (SAR) will facilitate better analysis and heighten user confidence in the audited financial statements”*. Besides, this Institute indicates the results on a survey, which highlights that: (a) Fifty-eight percent of respondents indicated that the auditor's report needs to provide more specific information about how the auditor reaches their opinion; (b) Seventy-five percent of respondents believe that risk factors associated with measurement uncertainties in an entity's financial statements should be included in the independent auditor's report. However, the CFA Institute is concerned by the content of the new report: *“Our principal concern is that the language used in the proposals prescribes a more subjective approach - what the auditor determines “key” or “critical” to be - rather than a more objective approach. The proposed subjective approach might easily allow an artful avoidance of providing any additional information whatsoever to investors”*. Besides, it recalls that: *“In our previous letters, (-) our request was to have the auditor report the most relevant of these same matters, whether we refer to them as key or critical, in plain, non-boilerplate language. With this*

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<sup>2</sup> The CFA Institute “is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide”. This Institute “seeks to promote fair and transparent global capital markets and to advocate for investor protections”.

*approach there would not be an increase in audit scope or additional procedures, rather the auditor would simply report what was done in the audit, using information already contained in the audit completion memo”.*

In its response to the PCAOB proposal, the Council of Institutional Investors - CII<sup>3</sup> (8 January 2014), also agrees with the disclosure of CAMs, but suggest a minor adjustment: *“However, we would revise the proposed model to provide that the auditor is required to communicate, at a minimum, an assessment of management’s critical accounting judgments and estimates based on the audit procedures the auditor performed.”*

### **French “Justification of Assessment” (JOA)**

A decade ago, similar proposals on disclosure of KAM by the auditors have been raised in France. Following the financial scandals of the new millennium, the French government adopted Financial Security Act (Assemblée Nationale française 2003), which among other require the auditors to justify their assessments (JOA) in order to help the users of the audit report to have a better understanding of the opinion provided by the auditor. More specifically, the French Code of Commerce states that the auditor justifies in its report the findings made during the audit (Article L. 823-9). This requirement has been in force from 2003 and then the subject of a specific professional standard “NEP 705: Justification of assessments” (Haut Conseil des Commissaires aux Comptes 2006), which basically explains how to implement the JOAs.

Five key points are emphasized in the standards: (a) the "justification of assessments" (JOA) carried out by the auditor helps to explain the auditor’s opinion; (b) the JOAs must allow the user of the report to better understand the reasons for which the auditor has issued his opinion on the financial statements; (c) the clarification of certain assessments cannot replace the need to make a qualified opinion or a disclaimer of opinion; (d) on the basis of professional judgment and in view of the steps taken throughout its mission, the auditor decides what justifications are important; (e) the JOAs generally relate to important matters for the understanding of the financial statements. These important matters are: options used in the selection of accounting policies or in their implementation, critical accounting estimates

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<sup>3</sup> CII is “a nonprofit organization of corporate, union, public and pension funds, foundations, and endowments, with combined assets That Exceed \$ 3 trillion Member funds are major shareowners. Generally with a duty to protect the retirement assets of millions of American workers”.

(including those involving professional judgment in their assessment), and the overall presentation of the annual and consolidated accounts.

In addition, the standards indicates that the formulation of the JOA:

- 1) must be clear and include for each assessment: (a) identification of the subject and reference to the notes; (b) a summary of the diligence taken by the auditor to base its assessment; (c) a conclusion, expressed positively, consistent with the opinion expressed on the financial statements.
- 2) should not provide specific insurance on isolated elements of the accounts subject to a JOA by the auditor .
- 3) appears in a separate part of the report, that can be found after the expression of the auditor's opinion.

To date, according to Gélard (2012), the French representative at the IAASB, France is the only country "*where an audit report with a non-standard part is disclosed, in which the auditor reports the work he conducted on the most sensitive points of the audit*". Thus, France "*was a laboratory since it has created a solution that makes the audit report more informative and aims to respond to users' criticisms about its completely standardized character*".

To our knowledge, no research study has examined the benefits and costs of the JOAs in France. One study conducted by consultants for the French institute of auditors (CNCC) examined users' perception of JOAs through interviews 34 persons (Footprint Consultants 2011). This study shows that JOAs are generally well perceived by users. They appreciate the flagging of areas of importance and take a closer look at the items referred to in the justification. We extend this study by examining the benefits and costs of JOAs, using archival data.

### **EXPECTED BENEFITS AND COSTS OF JOAs**

The expected benefits and costs of JOAs must be considered along with its dual nature. On the one hand JOA may be viewed as a pure supplementary information in the audit report. This conception leads to appreciate its benefits through its informative content which can namely been measured by empirical studies based on market reactions (Holt and Moizer 1990). On another hand, this paragraph can be viewed as a new procedure imposed to auditors. This latter conception leads to appreciate its benefits and costs in terms of audit quality, cost or/and efficiency.



## **Market reaction to JOAs**

There are two competing views about the economic consequences of the JOAs. The first approach considers that the information asymmetry is reduced between auditors and users of annual reports when JOAs are disclosed. In this case, JOAs could be an appropriate solution to the information needs of users. Insofar as the JOAs can provide new information to users of annual reports, we may find that the financial market reacts to their disclosure.

The second approach considers this type of disclosure as symbolic; it does not modify the behavior of investors and auditors. Academic research on the content of audit reports generally shows that the information content of audit reports is very low. Church et al. (2008) conclude that the audit report is mainly symbolic. This may even to be the case when the auditors issue a going-concern opinion, because investors permanently revise their expectations and do not wait for the auditor report. In this context, the reaction of the financial market does not depend on the content of the audit report, even if this report is more detailed. In other words, it is likely that the JOA have no informative value. This is especially the case when the detailed audit report is too standardized (“boilerplate”), or too complex (in terms of readability), or too heavy to digest (due to cognitive overload).

## **JOA and audit quality**

JOA could results in better quality audit. Disclosing that some key elements were analyzed may make auditors feel more accountable for matters to be reported, leading them to make additional efforts to analyze these elements. Some investors believe in such a positive effect. For example, in its response to the ED of the IAASB, CII (2014) argues that we could anticipate “*quality competition among audit firms, particularly in the area of professional skepticism, [which] enhance the value of the audit to investors.*” Moreover, these key elements are more visible to users, which may increase the costs to the auditor if problems occur with these elements subsequently. However, such a phenomenon is less likely in France, where a minor investors’ protection lowers the probability that auditors may pay significant penalties for material misstatements, whether caused by fraud or error.

## **JOAs and audit fees**

JOA may results in additional audit costs because of increased audit efforts as well as reporting costs. Auditors may increase their procedures to respond to the higher liability and reputation risk associated with JOAs, and develop quality control processes as well as the discussions of

the form and content with senior management and the audit committee, which are incurred by the most senior members of the engagement team (IAASB, 2012b).

Nevertheless, the JOAs requirements should not represent a significant departure from other audit requirements. Moreover, it is likely that most of those costs might be recurring since auditors may standardize their reporting within their audit firms, which reduces costs. In addition, for a given clients, if the same issue shows up in the next year, the reporting costs should be much lower. Overall, stakeholders seem to believe that there will be no additional material costs associated with KAMs. For example, the PCAOB (2013) “*does not anticipate significant additional costs*”. This view is shared by the CFA Institute, which, in its reply to the ED of the IAASB, says “*We do not believe that there would be additional material costs for communicating critical audit matters*”.

### **JOA and audit report lag**

JOA may affect the efficiency of the audit the audit. In particular, the audit report lag could be extended. In fact, the “*effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit*” (PCAOB 2013). Auditors’ response to this additional work may be to reduce the effort on other elements (review and completion of the audit work), add more resources, or surely delay the issuance of the audit report. In addition, discussion of the form and content of JOAs with management and audit committees prior to issuing the auditor’s report may also delay the issuance of the auditor report. Indeed, the IAASB (2012b) indicates that the more iterative process to finalize the auditor’s report may affect the timing of release of the financial statements and the auditor’s report.

## **SAMPLE SELECTION AND EMPIRICAL MODELS**

### **Sample**

Our sample covers the years 2000-2011. This period includes the first year of application of JOAs in France (2003) and allows thus some pre/post comparisons. To create our sample, we start with the list of companies composing the SBF 120 index, which is based on the 120 largest market capitalizations in Euronext Paris, in December 2011. We exclude non-French companies because their auditors are not subjected to the JOAs requirement and companies in the financial services sector. We require firm-year observations to have the annual financial statements available on the French market authority (Autorité des Marché Financiers) or

another WEB source. In addition we require firm-year observations to have the necessary financial data on the Wordscope database. We also require valid returns data from the Datastream database, non-missing audit fee data from the annual report (for the audit fee model) as well as the filing date on the French market authority WEB site (for the audit delay model). These procedures leave us with 815 firm-year observations (101 unique firms) for the market reaction model, 462 firm-year observations (101 unique firms) for the audit quality test, 721 firm-year observations (96 unique firms) for the audit fee model, and 953 firm-year observations (103 unique firms) for the audit delay analysis. Different samples were thus built for each of our four empirical models. In order to clarify their presentation, descriptive statistics are provided in each correspondent Table and not globally.

### **Empirical Models**

We test four different models to understand what the introduction of the JOA changed in France: a model to assess its information content (market reaction) and three models to assess three key features of the audit: its quality (proxied by a measure of earnings management), its cost (measured by audit fees) and its efficiency (measured by audit report delay).

We use five tests variables. First, *JOA*, an indicator variable equals to one if the company's auditor report includes justification of assessments, and zero otherwise. *JOA* allows us to test the effect of the JOA requirement. To examine whether the effect is larger in the first year of the requirement, we use *JOA\_FIRST*, an indicator variable equal to one for the first year the company's auditor report includes justification of assessments, and zero otherwise. To examine the effect of the number of matters, we use *NB\_JUSTIF*, the total number of matters mentioned in the justification of assessments section of the audit report. To examine the effect of new matters mentioned after the first year, we use *%NEW\_JUSTI*, the percentage of new matters in the JOA section of the current year (number of new matters / total number of matters). Finally, we examine the effect of the readability of the justifications paragraphs using *SCOLARIUS*<sup>4</sup>, a measure of readability developed for French texts (the higher the score, the more difficult the text to read).

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<sup>4</sup> Scolarius was developed by Influence Communication for French texts and is inspired by the Flesh Formula, Fog Index, Fry readability Score, and Easy Listening Formula. More information on the index is available at <http://www.scolarius.com>.

We use firm fixed effect models to test the effect of JOAs. By including companies as fixed effect, these models control for all time-invariant unobserved variables, just as if they had been included in the model. As a consequence, we cannot include variables that do not change over time such as industry and number of subsidiaries. The effect of these variables being included the firm fixed effects.

*Model 1: Market reaction analysis*

The first model allows us to examine the reaction of the financial market when JOAs are disclosed. More precisely, we conduct an event study to measure the cumulative abnormal returns (*CAR*) around the announcement date.<sup>5</sup>

$$|CAR| = \beta_0 + \beta_1 JOA + \beta_2 JOA\_FIRST + \beta_3 NB\_JUSTIF + \beta_4 \%NEW\_JUSTI + \beta_5 SCOLARIUS + \beta_6 LN\_MARKET\_CAP + \beta_7 FILING\_DELAY + \beta_8 MB + \beta_9 DEBT + \beta_{10} VAR\_NI\_TA + \beta_{11} ROA + \beta_{12} IFRS + \beta_{13} CROSS\_LIST + firm\ fixed\ effects + year\ fixed\ effects + \varepsilon \quad (1)$$

We use the absolute value of cumulative abnormal returns (*|CAR|*) over the filing and the following day. If the JOAs reduce the information asymmetry, the coefficient on *JOA* will be positive. That effect should be stronger for the first year JOAs are disclosed than in subsequent years where that information is repeated. We thus expect the coefficient on *JOA\_FIRST* to be positive. Because more matters provide more information about the audit, and accordingly do reduce more intensively the information asymmetry, we expect a positive coefficient on *NB\_JUSTI*. As for *JOA\_FIRST* we expect that when new matters are disclosed, the market reaction will be higher. We then expect the coefficient on *%NEW\_JUSTI* to be positive. Finally, less readable JOAs audit report sections make it more difficult for investors to understand the information provided in the JOAs. We then expect a negative coefficient on *SCOLARIUS*.

We control for firm size (*LN\_MARKET\_CAP*), delay in filing the annual report (*FILING\_DELAY*), market-to-book ratio (*MB*), leverage (*DEBT*), variation in net income

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<sup>5</sup> If such an analysis may be really useful, we also agree that an event study has two main limitations. First, it appears that the audit report is included in the annual report, which means that it is extremely difficult to isolate the informative value of the audit report. Second, to assess the information content of the audit report, it is necessary that the financial market has no access to this information prior to the date of announcement. For a researcher, it is very difficult to control what is already expected by the market.

(*VAR\_NI\_TA*), return on assets (*ROA*), whether the firm use the IFRS (*IFRS*), whether the firm is cross-listed in the U.S. (*CROSS\_LIST*), as well as for firm and year fixed effects. The Appendix summarizes each variable's definition.

*Model 2: Audit quality analysis*

Our second model allows us to assess the impact of the JOAs disclosure on audit quality. Following previous research we use unexpected accruals as a measure of audit quality. We estimate the following model to examine the relation between audit quality and the JOAs.

$$\begin{aligned}
 |UNACC| = & \alpha_0 + \alpha_1 JOA + \alpha_2 NB\_JUSTIF + \alpha_3 \%NEW\_JUSTI + \alpha_4 LOGASSETS \\
 & + \alpha_5 DEBT + \alpha_6 ROA + \alpha_7 LOSS + \alpha_8 CROSS\_LIST + \alpha_9 TWOBIG4 + \\
 & \alpha_{10} ONEBIG4 + \text{firm fixed effects} + \text{year fixed effects} + \varepsilon
 \end{aligned} \tag{2}$$

We use the absolute value of unexpected accruals (*|UNACC|*). These accruals are generated by the modified Jones (1991) approach (Dechow et al. 1995). If the JOA have an effect on audit quality, then we expect JOAs to be negatively associated with *|UNACC|*. To test this model, we use three variables of interest: *JOA*, *NB\\_JUSTI* and *%NEW\\_JUSTI*. Following prior research (Becker et al. 1998; Frankel et al. 2002; Ashbaugh et al. 2003), we also control for firm size (*LOGASSETS*), leverage (*DEBT*), profitability (*ROA* and *LOSS*), and whether the auditors dyad is composed of two Big 4 auditors (*TWO\\_BIG4*) or one Big 4 and a non-Big 4 (*ONE\\_BIG4*). These two last variables allow to assess the quality of auditors in France, where companies are forced to use two auditors (Francis et al. 2009).

*Model 3: Audit Fee Analysis*

We assess the impact of JOA on the audit fees using the following model, that we estimate for the period for which this information is available (2003-2008; audit fees were not published in France before 2003).

$$\begin{aligned}
 LOGAUDFEES = & \gamma_0 + \gamma_1 NB\_JUSTI + \gamma_2 \%NEW\_JUSTI + \gamma_3 LOGASSETS + \\
 & \gamma_4 INV\_REC + \gamma_5 DEBT + \gamma_6 ROA + \gamma_7 LOSS + \gamma_8 CROSS\_LIST \\
 & + \gamma_9 TWO\_BIG4 + \gamma_{10} ONE\_BIG4 + \gamma_{11} BUSY\_SEASON + \\
 & \text{firm fixed effects} + \text{year fixed effects} + \varepsilon
 \end{aligned} \tag{3}$$

We use the log of total audit fees paid to the pair of auditors as the dependent variable (*LOGAUDFEES*). Given that the publication of the audit fee data started the same as the JOAs requirement, we examine the effect of the JOAs using the number of matters mentioned in the justification of assessments section of the auditor report (*NB\_JUSTI*) and of new matters mentioned in a given year (*%NEW\_JUSTI*). If JOAs increase audit efforts and reporting costs, we expect that these two coefficients will be positive. Following previous audit fee studies (see Hay et al. 2006) we also control for various determinants of audit fees. In addition to the control variables introduced in the previous model, we control for receivables and inventory intensity (*INV\_REC*) and whether the firm's year end is a 31<sup>st</sup> of December (*BUSY\_SEASON*).

#### *Model 4: Audit Report Lag Analysis*

Our last model allows to assess the impact of the JOA on auditors' efficiency. We use the following regression model to examine the association between the JOA and audit report lag:

$$\begin{aligned}
 LOGAUDLAG = & \Omega_0 + \Omega_1 JOA + \Omega_2 JOA\_FIRST + \Omega_3 NB\_JUSTI + \\
 & \Omega_4 \%NEW\_JUSTI + \Omega_5 LOG\_ASSETS + \Omega_6 DEBT + \Omega_7 ROA + \\
 & \Omega_8 LOSS + \Omega_9 CROSS\_LIST + \Omega_{10} TWO\_BIG4 + \\
 & \Omega_{11} ONE\_BIG4 + \Omega_{12} BUSY\_SEASON + \text{firm fixed effects} + \\
 & \text{year fixed effects} + \varepsilon
 \end{aligned}
 \tag{4}$$

*LOGAUDLAG* is the number of calendar days between the date of the audit report and the company's year-end. The coefficient on *JOA* captures the change in reporting lag associated with the JOAs reporting requirement while the coefficient on *JOA\_FIRST* measures the differential impact for the first year. As for the fee model, we expect positive coefficients on *NB\_JUSTI* and *%NEW\_JUSTI*. The other variables are the same as those introduced in the audit fees model.

APPENDIX shows a description of the dependent variables used in each of those four models, the five test variables and the different control variables.

## **EMPIRICAL RESULTS**

### **Market reaction**

Panel A of Table 1 presents the descriptive statistics for the test variables and the dependent variable (*CAR*). For the JOA period, 9.23 percent of the JOA are first time implementation of

the JOA (*JOA\_FIRST*) and following the first implementation, 16 percent are new matters (*%NEW\_JUSTI*). On average, the justification section of the audit report includes 2.5 audit matters and have a level of readability complexity of 169<sup>6</sup>. Over the sample period, the average absolute CAR around the filing date of the annual report is 0.0156. But contrary to the expectation, univariate statistics show that absolute CAR are significantly lower with JOA requirement (0.0206 without JOAs and 0.0145 with JOAs). The results in Panel B show that the introduction of JOAs has no impact on the reaction of the financial market. In model 1a, which covers the whole period 2000-2011, none of the five variables related to JOA (*JOA*, *JOA\_FIRST*, *NB\_JUSTI*, *%NEW\_JUSTI* and *SCOLARIUS*) is statistically significant. Similar results are obtained in model 1b, which only covers a shorter period during which the auditors are required to disclose the JOA (2003-2011). Thus, we do not find any evidence that JOAs have any informative value over that provided in the rest of the annual report.<sup>7</sup>

**[INSERT TABLE 1]**

**Unexpected Accruals**

Panel A of Table 2 presents the descriptive statistics for the test variables and the dependent variable (*UNACC*). Even if the sample is smaller than for the market reaction model, the average for *%NEW\_JUSTI* and *NB\_JUSTI* are similar with values of 15 percent and 2.5 respectively. Contrary to the expectation, the unexpected accruals are larger in the JOA period (.0469) than before (.0736), but this difference is marginally significant at 10 percent.

Panel B of Table 2 shows that this difference does not hold with the multivariate analysis. Indeed, the variables *JOA*, *NB\_JUSTI* and *%NEW\_JUSTI* are never significant whether in the full sample (models 2a to 2c) or in the JOA period (model 2d). The introduction of the JOAs does not affect the level of unexpected accruals and accordingly, there is no evidence that JOAs are associated with improved financial reporting quality.

**[INSERT TABLE 2]**

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<sup>6</sup> The different level of complexity, as measured by *SCOLARIUS*, are the following : - 50-89 : primary school, - 90-119 : high school, - 120-149 : college, - 150-189 : university, above 190 : expert. The JOAs' formulation are thus tailored for an university audience.

<sup>7</sup> It is interesting to note that, controlling for all time-invariant unobserved variables with the firm fixed-effects, none of the control variables are statistically significant, even if the models 1a and 1b accounts for 25 and 28 percent of the variance respectively.

### **Audit fees**

As shown in Panel A of table 3, the average total audit fees for both auditors are €5.96 millions. As shown in Panel B, the coefficients on *NB\_JUSTI* and *%NEW\_JUSTI* are not significant, suggesting that the audit fees do not vary with the number of matters in the justifications nor the introduction of new matters in a given year. Thus, the additional work required for the determination, preparation of language for communication, and documentation of critical audit matters in the audit report seems not to alter the amounts paid by the clients. This suggests that these extra costs are marginal. It should be reminded, however, that because audit fees are not available for the pre-JOA period, we can only test the effect on audit fees of the number of matters and of the introduction of new ones, and not of the implementation of JOA section itself.

In this model, after controlling for all time-invariant unobserved variables with the firm fixed-effects, the size of the company (*LOG\_ASSETS*), its cross-listing in the U.S. (*CROSS\_LIST*) and the presence of a Big Four in its auditors' dyad (*TWO\_BIG4* and *ONE\_BIG4*) are associated with higher audit fees. These results are consistent with those of Gonthier-Besacier and Schatt (2007)

**[INSERT TABLE 3]**

### **Audit report lag**

As shown in Panel A of Table 4, the average audit report delay over the sample period is 84.5 days, almost three months. The delay has reduced by only 3 days after the JOAs' introduction, this impact being non-significant. As shown in Panel B, when we control for other variables, JOAs are associated with an increase delay as evidenced by the positive and significant coefficients on JOA in models 3a, 3b and 3c. The delay does not depend on the number of justifications (*NB\_JUSTI*) or on the disclosure of new matters (*% NEW\_JUSTI*). However, in model 3d, for the JDA period, the coefficient on *NB\_JUSTI* is positive and significant (one tail test,  $p=.05$ ). These results suggest that the more iterative process to finalize the auditor's report associated with JOAs affects the timing of the auditor report.

Other variables influence the audit lag. It increases when the financial situation is more difficult, that is to say when corporate debt increases (*DEBT*) and when the performance is lower (*ROA*) or very poor (*LOSS*).



**[INSERT TABLE 4]**

## **CONCLUSION**

This study examine how the introduction of JOAs in France affects the investors (market reaction), as well as the audit quality, its cost and efficiency. We find that these effects are almost inexistent: there are no clear benefits or costs. Indeed, the market does not react to JOAs, regardless the number of justifications. Besides, JOAs are not associated with better audit quality (measured with unexpected accruals) or audit fees. The only effect that we find is a slight increase in audit report lag associated when more matters are mentioned in the JOAs. These findings suggest that the JOAs disclosed by French auditors are not be as informative as regulators expected and have not altered the quality of the audit as well as its costs.

However, our results, and their potential consequences for future regulation concerning KAM, should be discussed carefully. First, the methods implemented in this paper suffer from many limitations (imperfection of earnings management measures as a proxy of audit quality; imperfection of audit fees as a measure of audit effort). Second, the French context is very specific. Almost all auditors' opinions are clean and the shareholders rarely sue auditors. In addition, the auditing standards regarding the identification are very general compared to the IAASB and PCAOB proposals.

## APPENDIX DESCRIPTION OF THE VARIABLES

Variables	Description
<b>DEPENDENT VARIABLES (One for each of the empirical models)</b>	
<b> CAR </b>	Absolute value of cumulative abnormal return over trading days $t_0$ to $t_{+1}$ , where day $t$ is the filing date ( <i>Model 1: Market reaction model</i> ).
<b> UNACC </b>	Absolute value of unexpected accruals from the Jones 1991 model, modified to correct for firm performance bias, applied to total accruals, and estimated cross-sectionally by industry (1-digit SIC) and by year ( <i>Model 2: Audit quality model</i> ).
<b>LOGAUDFEES</b>	Natural log of the total audit fees charged by the joint auditors ( <i>Model 3: Audit fee model</i> ).
<b>LOGAUDLAG</b>	Number of calendar days between the date of the audit report and the company's year-end. ( <i>Model 4: Market reaction model</i> ).
<b>TEST VARIABLES</b>	
<b>JOA</b>	Dummy variable equal to one when the company's auditor report includes justification of assessments, and zero otherwise.
<b>JOA_FIRST</b>	Dummy variable equal to one for the first year the company's auditor report includes justification of assessments, and zero otherwise.
<b>NB_JUSTI</b>	Total number of matters mentioned in the justification of assessments section of the auditor report
<b>%NEW_JUSTI</b>	Percentage of new matters in the auditor's report in the justification of assessments section of the current year auditor report (number of new matters / total number of matters)
<b>SCOLARIUS</b>	Scolarius is a measure of readability developed by Influence Communication for French texts and is inspired by the Flesh Formula, Fog Index, Fry readability Score, and Easy Listening Formula. The higher the score the higher the level of difficulty. The score typically ranges between 50 and 250. More information on the index is available at <a href="http://www.scolarius.com">http://www.scolarius.com</a> .
<b>CONTROL VARIABLES</b>	
<b>LN_MARKET_CAP</b>	Natural log of Market capitalization at the end of the year
<b>M_B</b>	Dummy variable equal to one if the French firm is cross-listed in the U.S. and zero otherwise.
<b>DEBT</b>	Company's total debt divided by total assets
<b>INV_REC</b>	Company's inventories and receivables divided by total assets
<b>VAR_NI_TA</b>	Variation of the net income divided by total assets
<b>ROA</b>	Return on assets
<b>IFRS</b>	Dummy variable equal to one if the firm uses IFRS and zero otherwise
<b>CROSS_LIST</b>	Dummy variable equal to one if the French firm is cross-listed in the U.S. and zero otherwise
<b>FILING_DELAY</b>	Number of days between the filing date of the annual report and the company's year-end
<b>TWO_BIG4</b>	Dummy variable equal to one when two Big 4 auditors are conducting the joint audit, and zero otherwise
<b>ONE_BIG4</b>	Dummy variable equal to one when one Big 4 and a non-Big 4 auditor, are conducting the joint audit, and zero otherwise
<b>LN_TOT_ASSETS</b>	Natural log of Total Assets at the end of the year
<b>LOSS</b>	Dichotomous variable equal to one when the company net income is negative, and zero otherwise
<b>BUSY_SEASON</b>	Dichotomous variable equal to one for companies with December 31 <sup>st</sup> yearend, and zero otherwise
<b>Firm fixed effect</b>	Firm fixed effect
<b>Year fixed effect</b>	Year fixed effect

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**Table 1. Market reaction associated with Justification of Assessments (JOAs)****Panel A - Descriptive statistics for test variables**

Variable	Total Sample	No JOAs (JOA = 0)	JOAs (JOA = 1)	Test	
	N=815	N=154	N=661	t value	Pr
CAR	0.0156	0.0206	0.0145	4.71	<.01
JOA_FIRST		0	0.0923		
%NEW_JUSTI		0	0.1604		
NB_JUSTI		0	2.4901		
SCOLARIUS		0	169.34		

**Panel B - Regression results by JOA period**

Parameter	Model 1a (Sample period, 2000-2011) N=815			Model 1b (JOA Period, 2003-2011) N=661		
	Coef.	Std. Err	Pr.	Coef.	Std. Err	Pr.
JOA	0.0088	0.0103	0.394			
JOA_FIRST	-0.0027	0.0063	0.667	-0.0014	0.0058	0.812
%NEW_JUSTI	0.0030	0.0024	0.225	0.0034	0.0023	0.151
NB_JUSTI	0.0001	0.0007	0.904	0.0001	0.0007	0.855
SCOLARIUS	0.0000	0.0000	0.752	0.0000	0.0000	0.716
ln_MARKET_CAP	-0.0001	0.0001	0.282	-0.0001	0.0001	0.265
FILING_DELAY	0.0000	0.0000	0.342	0.0000	0.0000	0.478
MTOB	0.0004	0.0004	0.362	-0.0004	0.0006	0.553
DEBT	0.0003	0.0006	0.590	0.0006	0.0007	0.446
VAR_NI_TA	-0.0025	0.0185	0.894	-0.0132	0.0193	0.494
ROA	0.0187	0.0213	0.380	0.0186	0.0237	0.432
IFRS	0.0084	0.0048	0.080	0.0064	0.0045	0.153
USA	0.0014	0.0027	0.610	0.0017	0.0030	0.566
Firm_Fixed Effects	incl.			incl.		
Year_Fixed Effects	Incl.			Incl.		
<b>F-Value</b>	2.27			2.130		
<b>Adj R-Sq</b>	0.255			<.01		

**Table 2. Unexpected Accruals association with Justification of Assessments**

**Panel A - Descriptive statistics for test variables**

Variable	Total Sample	No JOAs (JOA = 0)	JOAs (JOA = 1)	Test	
	N=462	N=29	N=433	t value	Pr
UNACC	0.0719	0.0469	0.0736	1.94	<.10
%NEW_JUSTI		0	0.1501		
NB_JUSTI			2.53		

**Panel B - Regression results by JOA period**

Variable	Sample period, 2000-2011									JOA Period, 2003-2011		
	Model 2a N=462			Model 2b N=462			Model 2c N=462			Model 2d N = 433		
	Coef.	Std. Err.	P	Coef.	Std. Err.	p	Coef.	Std. Err.	p	Coef.	Std. Err.	p
JOA	-0.0251	0.0453	0.58	-0.0272	0.0491	0.58	0.0175	0.0433	0.69			
%NEW_JUSTI				0.0009	0.0074	0.91	-0.0003	0.0079	0.97	-0.0029	0.0087	0.74
NB_JUSTI							0.0107	0.0250	0.67	0.0099	0.0257	0.70
LOG_ASSETS	-0.0082	0.0569	0.70	-0.0083	0.0571	0.70	-0.0083	0.0572	0.70	-0.0124	0.0787	0.63
DEBT	-0.0396	0.0542	0.67	-0.0419	0.0543	0.66	-0.0403	0.0544	0.67	-0.0932	0.0729	0.38
ROA	-0.0313	0.0213	0.90	-0.0320	0.0213	0.90	-0.0296	0.0213	0.91	0.1558	0.0256	0.59
LOSS	0.0241	0.2614	0.37	0.0240	0.2618	0.37	0.0233	0.2622	0.38	0.0461	0.2921	0.13
CROSS_LIST	-0.0264	0.0934	0.45	-0.0268	0.0954	0.45	-0.0266	0.0956	0.45	-0.0215	0.1063	0.60
TWO_BIG4	-0.0755	0.0266	0.19	-0.0750	0.0267	0.19	-0.0757	0.0267	0.19	-0.0706	0.0300	0.37
ONE_BIG4	-0.0128	0.0350	0.81	-0.0126	0.0353	0.82	-0.0134	0.0353	0.81	0.0224	0.0405	0.76
Firm Fixed Effects	Incl.		<.01	Incl.			Incl.			Incl.		
Year Fixed Effects	Incl.		<.01	Incl.			Incl.			Incl.		
<b>F-Value</b>	2.72			2.69			2.72			2.71		
<b>Adj R-Sq</b>	0.475			0.475			0.475			0.493		

**Table 3. Audit fees****Panel A - Descriptive statistics for test variables**

<b>Variable</b>	<b>JOA Period (2003-2011) N=721</b>
<i>AUDFEES (millions)</i>	5.96
<i>LOGAUDFEES</i>	7.99
<i>%NEW_JUSTI</i>	0.17
<i>NB_JUSTI</i>	2.56

**Panel B - Regression results for JOA period**

<b>Variables</b>	<b>Coef.</b>	<b>Model 4 N=721 Std. Err.</b>	<b>p</b>
<i>NB_JUSTI</i>	0.0092	0.0111	0.41
<i>%NEW_JUSTI</i>	-0.0125	0.0341	0.71
<i>LOG_ASSETS</i>	0.4924	0.0883	<.01
<i>INV_REC</i>	0.0854	0.0786	0.67
<i>DEBT</i>	-0.1761	0.0343	0.19
<i>ROA</i>	-0.3343	0.1980	0.32
<i>LOSS</i>	-0.0749	0.3347	0.05
<i>CROSS_LIST</i>	0.2509	0.0378	<.01
<i>TWO_BIG4</i>	0.5719	0.1333	<.01
<i>ONE_BIG4</i>	0.6329	0.0476	<.01
<i>BUSY_SEASON</i>	0.0504	0.1107	0.65
<i>Firm_Fixed Effects</i>	<i>Incl.</i>		<.01
<i>Year_Fixed Effects</i>	<i>Incl.</i>		<.01
<b>R-Squared</b>	0.979		
<b>F-Value</b>	236.27		<.01

**Table 4. Audit lag**

**Panel A - Descriptive statistics for test variables**

Variable	Total Sample	No JOAs (JOA = 0)	JOAs (JOA = 1)	Test	
	N=953	N=210	N=743	t value	Pr
Audit Delay	84.55	86.89	83.89	1.324	0.187
JOA_FIRST		0	0.109		
NB_JUSTI			2.56		
%NEW_JUSTI		0	0.164		

**Panel B - Regression results**

Variables	Sample period, 2000-2011 (N=953)									JOA Period, 2003-2011 (N=743)		
	Model 3a			Model 3b			Model 3c			Model 3d		
	Coef.	Std.E.	P	Coef.	Std.E.	p	Coef.	Std.E.	p	Coef.	Std.E.	P
JOA	<b>0.2044</b>	<b>0.0709</b>	<b>&lt;.01</b>	<b>0.2432</b>	<b>0.0937</b>	<b>0.01</b>	<b>0.1762</b>	<b>0.0738</b>	<b>0.02</b>			
JOA_FIRST				-0.0355	0.0561	0.53				-0.0164	0.0515	0.75
NB_JUSTI							0.0119	0.0086	0.17	0.0160	0.0305	0.10
%NEW_JUSTI										-0.0173	0.0099	0.57
LOG_ASSETS	0.0362	0.0541	0.11	0.0364	0.0541	0.11	0.0361	0.0543	0.11	0.0061	0.0730	0.84
DEBT	0.4532	0.0471	<.01	0.4549	0.0471	<.01	0.4354	0.0472	<.01	0.4536	0.0635	<.01
ROA	-0.7322	0.0229	<.01	-0.7306	0.0229	<.01	-0.7455	0.0229	<.01	-0.9685	0.0294	<.01
LOSS	-0.0601	0.2571	0.05	-0.0597	0.2572	0.05	-0.0631	0.2571	0.04	-0.0850	0.2766	0.01
CROSS_LIST	0.0146	0.0957	0.70	0.0153	0.0957	0.69	0.0159	0.0965	0.68	0.0397	0.1077	0.36
TWO_BIG4	-0.1535	0.0310	<.01	-0.1537	0.0310	<.01	-0.1473	0.0310	<.01	-0.0168	0.0333	0.82
ONE_BIG4	-0.0933	0.0381	0.05	-0.0945	0.0382	0.05	-0.0876	0.0381	0.06	0.0301	0.0428	0.64
BUSY_SEASON	-0.0004	0.0848	1.00	-0.0009	0.0849	0.99	0.0010	0.0848	0.99	0.0164	0.0999	0.87
Firm_Fixed Effects	Incl.		<.01	Incl.		<.01	Incl.		<.01	Incl.		<.01
Year_Fixed Effects	Incl.		<.01	Incl.		<.01	Incl.		<.01	Incl.		<.01
<b>R-Squared</b>	0.697			0.697			0.698			0.763		
<b>F-Value</b>	15.64			15.5			15.54			16.89		
			<.01			<.01			<.01			<.01