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External Auditors, Audit Committees and Earnings Management in France

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ABSTRACT

We investigate the effect of various audit quality dimensions (i.e. auditor reputation and tenure, audit committee existence and independence) on earnings management in France. We thus contribute to the empirical audit quality literature in a Continental European environment that markedly differs from the USA in terms of auditing and corporate governance. The main findings are that: (1) the presence of an audit committee (but not the committee's independence) curbs upward earnings management; and (2) the presence of a Big Five auditor makes no difference regarding earnings management activities. Implications of these findings are discussed with regard to the specificities of the French auditing and governance settings. In particular, although the audit committee acts as a device to control the more egregious (i.e. income-increasing) forms of earnings management, the monitoring incentive of outside directors may be hampered by the collective board responsibility for financial reporting

quality. Second, the lack of differentiation among Big Five auditors in terms of accounting conservatism is consistent with the lower litigation risk offered by the French Civil Code (vs. the US Common Law system), which is likely to eliminate the deep pockets incentive for investors.

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Notes

1. See, for instance, DeFond and Jiambalvo (1993), Dechow et al. (1996), Becker et al. (1998), Francis et al. (1999), Peasnell et al. (2000a), Frankel et al. (2002), Klein (2002a), Kim et al. (2003), Xie et al. (2003) and Bédard et al. (2004).

2. The effectiveness of such regulation, for example, in Italy, has not been demonstrated. In practice, it is more likely to result in a game of musical chairs than in a strengthening of auditors' independence.

3. It is not possible for a manager to dismiss an auditor during the course of his mandate, other than by a Court decision. Judges may revoke the auditor if it can be proved that the latter has committed a fault which caused damages to the audited company (this is an extremely uncommon situation).

4. The formation of audit committees is not mandatory in the UK.

5. The methodology used for estimating abnormal accruals does not apply to financial companies.

6. Some authors (Peasnell et al., 2000b, Xie et al., 2003) posit that only the short-term component of accruals can actually be manipulated, and as such keep only these in their model. We prefer considering also the long-term component of accruals, because of the importance placed on provisions for risks and charges in the French accounting system. The indirect formula, based on balance sheet and income statement items, is preferred given that cash flow statements are not systematically supplied in the French Diane database at the time of our study. The items used in this formula are the ones prescribed by the French accounting format, replicated in Diane. English translations of these items are recommended by the authors so that the reader may be able to appreciate the equivalent in an Anglo-Saxon accounting system.

7. Long-term deferred expenses constitute amortisable entries in French financial statements; as such, they are added to the amortisable fixed assets.

8. If this coefficient is expected to be positive for industries where companies have a structural need for working capital, it should be negative for industries in which companies post a surplus in working capital.

9. The initial 102 listed companies were classified into 54 industries. Of the resulting 162 industry-years, 16 did not meet the minimum data requirement of six observations to estimate the accruals models.

10. The professional standard states that the two co-auditors agree on the audit opinion. In a case of deep divergence, it remains possible to include both opinions in the audit report (extremely rare case).

11. Early 1998, three groups of auditors are identified on the French market of listed companies: (1) the Big Six; (2) seven national networks called the Majors (Mazars & Guérard, Salustro Reydel, Amyot Exco, Fidulor, Calan Ramolino, Constantin, BDO Gendrot); and (3) the other Local audit firms. Among the Majors, two networks (Mazars & Guérard and Salustro Reydel) are distinguishable by their revenues which are fairly close to those of the Big Six (Piot, 2001, p. 492).

12. We have also considered the fact that audit committees may be composed of 100% independent members. But this alternative concerns only 11% of available observations, which severely limits the power of statistical tests.

13. The question of the shareholder linkage is not addressed in detail in the Viénot Reports of 1995 and 1999. The Bouton Report (2002, p. 10) stipulates that 'Beyond a threshold of 10% in capital or in voting rights, it is suitable that the board, based on the report of the nomination committee, should systematically inquire into the independent qualification, taking into account the capital structure of the company and the potential for conflicts of interest.' By default, all the directors who hold more than 10% of the capital or voting rights are not considered to be independent; the same applies to the representatives of other companies that pass one of these thresholds.

14. The results reported are potentially biased by the arbitrary dichotomy used. It is also possible that the relation between a high tenure and a loss in audit quality is not linear. Furthermore, considering only the tenure of the leading auditor inevitably causes a loss of information. In order to integrate the joint-auditorship, these tests were replicated with the average tenure of co-auditors, and the results were insignificant.

15. Given the strong contingency between the presence of an audit committee (AC = 1) and the presence of a committee independent in majority (ACInd50 = 1), hypotheses H3 and H4 are tested separately.

16. This control variable is included only when abnormal accruals are derived from the Jones Model. The control for cash flows is endogenous when the CFO Model is used.

17. Regressions with the ACInd50 variable are not reported for clarity. They are qualitatively similar to those of Table 5, excepted that ACInd50 is never significant.

18. See Piot (2004) for an empirical analysis in France, and for a review of studies on the determinants of the existence of audit committees.

19. The univariate effect of the presence of an audit committee has also been tested by regressing signed abnormal accruals on AC. The results are as follows (both regressions exhibit statistically significant coefficients for AC at $p < 0.05$ one-tailed):

As a whole, regression diagnostics (VIF) show that multicolinearity problems are not likely to affect the multiple regressions, either traditional or 2SLS analyses.

20. T. Breton is the current Minister for the Economy. His words are translated from the business press (Les Echos, No. 19446, 30 June 2005, p. 5).