Auditing and Private Capital Formation: A Field Study

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ABSTRACT

Audited financial reports are supposed to promote capital formation by reducing information asymmetry between companies and investors. Although regulatory requirements based on this proposition have been in place for eight decades, empirical evidence on its validity remains scarce. We interview a small sample of private company CFOs, auditors, bankers, board members, bonding agencies, and private equity firms to learn why and how private companies hire auditors, and how audited financial statements are used to make decisions. We find that a wide variety of agents demand audited financial statements of such companies, and their management selects the auditor. When the demand for audit arises from current or potential owners of equity, CFOs and users prefer a Big-4 audit firm. Other users (e.g., customers and creditors) are indifferent between large and small audit firms. CFOs and users want auditors to improve the reliability of financial statements, help identify internal control and governance issues, and provide general business advice to increase the company’s profitability. Users rely on cash flows, casting a skeptical eye on accounting accruals. Users often hire additional experts to examine (audited) accruals before relying on them for making their decisions. The results show that auditing appears spontaneously to mediate the capital formation relationship between private firms and their investors. Since it also appeared extensively in publicly traded firms in the pre-regulation era, more work is needed to identify and estimate the value added by regulatory audit requirement for such firms.

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1. Introduction

We conduct comprehensive interviews with a variety of agents who demand, purchase and supply audit services to private (i.e., not publicly traded) companies not bound by audit requirements of securities laws to address the following questions: 1) Who demands an audit in the market for private capital? 2) Who chooses the auditor and how is the auditor chosen? 3) How do companies and users assess audit quality? 4) How are audited accounting numbers used in decision models?

Most audit research concerns public companies where certain agency relationships and regulatory mandate for independent audit dominate our perspective, and influence the data we gather and analyze. This field study affords us the opportunity to observe and gather data on variables that are not normally included in the standard models of auditing, and the potential to gain insights into alternative sources of demand for audit, interactions between audit and non-audit services provided by the audit firms, and new stylized facts and explanations to broaden our understanding of auditing. The evidence gathered highlights several areas where the extant academic models and assumptions deviate from existing practice in important respects. Some conjectures about implications of the findings for regulation of audits in public markets are also included.

We investigate these questions by interviewing 27 principal participants in the field and scrutinizing relevant primary documents for specific company audits. We start by interviewing the CFOs of eleven private companies about how and why they had hired an auditor (six had
engaged Big-4 auditors, five engaged others). We then interview 5 auditors (3 Big-4, 2 others) who serve private companies, and also interview various users of private company audited financial statements (4 bankers, 3 board members, 2 bonding [surety] agencies, and 2 private equity firms). We ask each user to give us a detailed example of what information they use from financial statements, what other sources of information affect their decisions, and the output of their analysis. One company provided a Request for Proposal (RFP) document used to hire an auditor and three Big-4 firms provided the bids they submitted in response to this RFP. Two bankers provided detailed examples of financial statements and other inputs that enter their models and the outputs of these models. A bonding agency provided a detailed example of how financial information is used to make a bonding decision. A consulting unit of a Big-4 accounting firm provided a detailed example of a “quality of earnings analysis” report that they had prepared for a private equity firm interested in buying a private company. The sources of data we gathered are summarized in Appendix 1.

Our results indicate that private demand for audit comes from a variety of agents such as bankers, directors, bonding [surety] companies, customers, employees, internal governance needs, management, other lenders, other (non-securities related) regulators, private equity firms, owners hoping to attract prospective buyers, and vendors. Management is especially responsive to demands from sources of equity capital, and tends to hire a Big-4 auditor. When demand for an audit comes from other sources, management is reluctant to provide audited (or any) financial statements, and is indifferent as to the size of the audit firm. When management is very reluctant to obtain an audit (usually on request from a bank), a Non Big-4 firm is hired at lower cost. Banks who ask for an audit report face resistance from client companies. Banks often accept
review reports, or a notice to reader engagement\(^1\) even when the size of the loan exceeds their normal threshold for requiring an audit. Companies are extremely reluctant to provide audited financial reports to their vendors. A vendor has to be a major shareholder or be involved in significant risk sharing arrangements with the company to be given such access.

In all eleven interviewed companies, management, usually the President or CEO, selected the auditor. Other financial executives—CFO or controller—were sometimes involved in the interview process, but they did not make the main decision. Seven of the companies we interviewed had a board of directors, and the board members were not involved in interviewing and choosing the auditor. In one company, the board chair was involved in the selection process, but the CEO clearly decided. In a second company, management decided to change the auditor and prepared an after-the-fact memo for the board to explain the decision. The board accepted the recommendation and voted to hire the new audit firm. In this case at least, the board can be said to have “overseen” the process, but it was not actively involved in interviewing or selecting the auditor.

The choice of the auditor was primarily based on personal relationships of individual audit partners with a senior member of management or the board chair. CFOs and other users thought that services of all Big-4 audit firms were undifferentiated commodities and the selection decisions were heavily influenced by attributes of and relationships with individual partners. Since there was little audit (or accounting) expertise-based differentiation, ability to deliver other services (tax and consulting) and relationship-based variables (responsiveness, fit, “makes me

\(^1\) Among the range of assurance services provided by audit firms, audit and review reports provide the highest and an intermediate level of assurance respectively. An accounting service provided by audit firms is not considered to be an assurance service, but there is some chance that a user may believe assurance is being provided because the name of an audit firm is on the report. Professional regulations require the audit firm to attach a “Notice to Reader” to inform users that no assurance work has been done on such accounting engagements.
feel special”) had a dominant role in the auditor selection process. Instead of the audit leading to an advantage in selling other services, capabilities in delivering other services often drove the auditor selection. Yet, in four companies, a Request for Proposal (RFP) was issued. Two of these RFPs were motivated primarily to get the lowest price, whereas the other two were motivated by search for the best auditor. All companies who issued a RFP had a board of directors.

Audit quality is assessed based on four key variables: comfort with the accounting numbers/systems, business advice, price, and connections with external networks. The auditor is clearly seen first as an accounting expert who is available 24/7 to provide advice on any accounting issue that arises. Responsiveness of the auditor was mentioned by every CFO as an important attribute. CFOs, bankers, and private equity owners discuss accounting issues directly with the auditor and assess the auditors’ depth of reasoning around complex accounting issues. CFOs and board members also want financial reports to be free of error, disclosures to be proofread, and treat the auditor as part of their company’s control system, that affords them some personal protection. They want advice on internal control matters, sometimes on governance, and assessments of the technical capability of the company’s finance staff.

CFOs and board members care deeply about the audit plan and the auditor is not free to allocate time and levels of expertise to whichever accounts (s)he deems important (as required by auditing standards). CFOs and users also want the auditor to provide as general business advice on “anything that will help the company be more profitable and more efficient.” Capability to provide business advice is a major selection consideration for auditors, therefore business advisory service capability tends to drive auditor choice, instead of the other way around. The audit fee (price) is always a consideration, though very low bids by auditors raise eye brows as to
whether the auditor understands the amount of work involved (in which case, (s)he may send an extra bill later), or will not do a quality audit. All CFOs in our sample wanted auditor involvement in tax compliance and tax planning. CFOs and users expect audit firms to connect them to broader industry networks including alternative sources of capital, potential customers and industry conferences, and other organizations such as tax authorities. There is little concern about conflict of interest or spillage of information to competitors. CFOs and users want industry specific business expertise, and expect transfer of information across companies filtered through auditor discretion.

Bankers, private equity purchasers, and even board members are skeptical about the reliability and validity of audited financial statement numbers. Since they have access to the auditor, these agents can directly examine audit working papers and/or ask questions directly to the auditor about internal control, the reliability of the numbers, and question the assumptions behind them. Some voiced concerns about IFRS being too “loose” or more politely “principles-based.”

Accounting numbers are used to corroborate information they receive from other sources. If the users are going to rely significantly on some accounting numbers, they often hire another expert to examine them in more detail. Audited numbers are often adjusted for biases arising from tax considerations, related party transactions, and various non-commercial arrangements and/or improper capital structure. Some known deficiencies of accounting (e.g., off-balance sheet leases) are adjusted for as part of the normal operating template used by banks. Financial information is combined with a variety of non-financial information indicators obtained from other sources, making it unlikely that any single financial statement number has a decisive impact on the users’ decisions. All users recast financial statements into some type of operating (or free) cash flow measure for their own use. Even users with sophisticated accounting
backgrounds do not rely directly on accounting measures. We see little evidence of functional fixation among users of private company financial statements.

Findings of this field study suggest that audit services play an important informational role in formation of private capital. By demanding and supplying audited financial reports, investors and managers gain a higher level of confidence. Willingness to incur this additional expense without regulatory pressure suggests that this cost is well worth the benefits as perceived by the parties. It is not unreasonable to infer that, absent availability of audit services, formation of private capital will be reduced.

It is worthwhile to compare and contrast these private firm findings with earlier reports on audits of publicly traded firms. Discussions of demand for public company audits usually focus on the influence of federal securities laws though some attention has been focused on private (especially bank related) versus public incentives for hiring auditors (Benston [1969]; Leftwich [1980]; Lennox and Pittman [2011]; and Minnis [2011]). More recently, debates about the U.S. JOBS Act of 2012 have also raised questions about the value of mandatory audit requirements, and whether exempting small companies from requirements of Securities laws will promote or impair capital formation in the US economy.

There have also been debates in auditing literature about (1) how an auditor should be appointed and (2) the extent of companies’ compliance with the requirements of the Sarbanes-Oxley Act [2002] to have auditors appointed by the audit committee consisting of independent members of their board of directors, instead of being appointed by their management (Dhaliwal et al., [2014], Fiolleau et al., [2013], and Mayhew and Pike [2004]). There is a literature on non-audit services provided to companies by their auditors, with special emphasis on examining
whether sale of audit and non-audit services by the same firm hurts the client company and its shareholders (Kinney et al. [2004], and Jamal and Sunder [2011]). Surveys of public company CFOs indicate that they emphasize accounting earnings rather than cash flows, and view the market as being functionally fixated or at least reacting mechanically to (manipulated) earnings per share (Graham et al., [2005]).

The remainder of the paper is organized as follows. Section 2 discusses the demand for auditing prior to the advent of federal securities laws and the subsequent quest to understand how a regulated audit profession functions. Section 3 explains our research design. Section 4 discusses our findings. Section 5 summarizes the evidence and discusses the implications for regulation of the audit profession.
2. Demand For Private Audits and Auditor Regulation

The North American audit profession developed in the late 1800s as Scottish and English Chartered Accountants followed their British clients across the Atlantic, as they invested in building infrastructure in the US and Canada (Allen [1993]). In the decades preceding the enactment of the U.S. federal securities laws in 1932 and 1933, accounting firms provided accounting, tax, and other business advisory services in addition to auditing (Zeff [2003]). About 82% of publicly traded companies on the New York Stock Exchange (NYSE) had engaged an auditor and issued audited financial statements to the public prior to advent of the legal mandate to hire an auditor (Benston [1969]). The federal securities laws imposed a mandatory audit requirement for publicly traded companies raising the rate of public company audits from 82% to 100%. Eight decades later, many think that public companies hire auditors to meet this regulatory requirement. However, historical evidence suggests otherwise; there were other market-derived incentives underlying the demand for audit. Our field study of private companies suggests that those incentives have not disappeared over time.

Present laws in the US (and many other developed financial economies including Canada and the UK) do not require private companies to hire an auditor. Why do so many of them still do? A recent study of tax reporting in the US suggests that about 40% of private companies have voluntarily chosen to be audited (Lisowsky and Minnis, [2013]). Various analyses of these privately audited companies tend to focus on bank and debt related reasons for hiring auditors (Leftwich [1980], Allee and Yohn [2009], Minnis [2011], and Lennox and Pittman [2011]). Our analysis shows that a much larger set of agents (and especially the suppliers of equity capital, not just debt) demand audited financial statements to support their contracts, decisions, and
transactions with private companies. When they hire and pay for the cost of audit, it is reasonable to infer that they find the cost of audit worth the benefits from engagements with such third parties.

3. **Research Method**

We collected data by interviewing participants (for about an hour each) and requesting primary documents as examples of the decision processes they described to us. Most interviews took place over the phone with two members of the research team present; both took extensive notes during the interview. Some face-to-face interviews also had two researchers present. Since CFO participants denied our requests to tape the interview sessions, our real time field notes are the primary source of data in this research. After each interview, one of the researchers summarized the interview, while the second researcher edited and reviewed the summary. Any discrepancies were resolved by discussion between the two researchers, and a final version of the session summary was agreed on. In some cases, a short follow-up phone interview was conducted with a CFO and/or auditor to clarify discrepancies in understanding between the two researchers. Interviews and summary preparation took ten months from September 2013 to June 2014.

We prepared for interviews by developing a template questionnaire for CFOs of companies (see Appendix 2). The questions focused on: obtaining background information on each company; how and why they hired an auditor; identities of the key users of audited financial statements; other expectations management had of the auditor (besides the audit report); other services the company purchased from the audit firm; method for judging the quality of audit services received; and whether the company cared about details of the audit plan (such as hours, allocation of staff to risk areas, seniority of staff, and hourly billing rates) as opposed to caring
only about the total audit fee. We also asked the CFOs to describe the attributes of an ideal partner they would want if their current engagement partner became unavailable. The interviewees received the script in advance. The script served as only a guideline for the discussion and allowed both sides to digress and pursue interesting avenues of discussion (Hirst and Koonce [1996]). Four companies had gone through a request for proposal (RFP) process so we asked these companies for a copy of their RFP. Only once company provided a copy of their RFP. For this company, three of the Big-4 audit firms bid for the audit. We obtained a copy of each bid directly from the bidding firms, and interviewed the respective bidding partners to ascertain their understanding of what the company was looking for, and how they sought to differentiate themselves from other Big-4 firms in competing for the engagement.

Next, we interviewed a host of users identified by the CFOs: four bankers, two bonding agencies, three directors of private companies, and two private equity firms. We asked them questions about why they wanted an audit, who they would have preferred as the auditor, what they wanted from the auditor besides an audit report, what communication they had with the auditor, how they judged audit quality, whether they cared about the internal details of the audit plan, and how the auditor conducted the audit.

We also asked the users to provide primary documents illustrating the type of information they access from various sources (financial and non-financial) and the outputs of their models for a specific case. One bank provided a detailed loan contract, an example of a template used to input financial statement data into their model, an example of the other types of non-financial information they input into their models, and the output from their model. Another bank provided a detailed description of its decision model, the inputs (financial and non-financial) that went into the model, and a copy of the output. A bonding [surety] company provided a detailed
example of what inputs they extract from a financial statement and what outputs they generate to
guide their decisions. Three directors described the measures they use to guide their
understanding of the companies they are involved with. The consulting unit of a Big-4
accounting firm provided a detailed example of a “quality of earnings” analysis they would
conduct for private equity firms showing a template of “adjustments” they look for. The
provision of these private documents made it easier for us to have a meaningful and probing
conversation with the participants, who were aware of (and had personally given to us) these
extensive private documents.

4. Findings
4.1. WHO DEMANDS AN AUDIT?

Our respondents identified a dominant user who had motivated them to hire an auditor (See
Table 1). Five companies identified the bank as the dominant user who demanded audited
financial statements. Four of these companies (80%) chose Non Big-4 auditors, while one chose
a Big-4 auditor. Four companies identified a desire to sell equity as the dominant reason for
hiring an auditor. All four of these companies hired a Big-4 Firm as auditor. One company
identified a customer as the dominant reason for hiring an auditor and hired a Non Big-4 Firm as
auditor. One company identified another regulator as the dominant reason for hiring an auditor
and hired a Big-4 firm as auditor. Audited financial statements were used for tax purposes, and
provided to equity owners, banks and customers. There was reluctance to provide audited
financial statements to vendors or other lenders (e.g., lessors). In industries where companies bid
to get a job (e.g., software, construction) there was a concern that customers were not just
interested in assessing liquidity and financial stability but also wanted to understand margins so
they could force price concessions during the bidding process. Attempts were thus made to
aggregate data to make it difficult for users to understand how margins are earned on different types of projects.

These patterns of engaging auditors are consistent with user preferences. We asked four bankers about their preference for auditor but they all claimed not to have one. Likewise, the two bonding [surety] companies claimed to have no preferred auditor. Bankers and bonding companies would give management wide latitude in choosing an auditor, being uncomfortable only if there was an extreme mismatch between the size of the company and the size of the audit firm. Bankers had lists of their preferred (or recommended) lawyers and valuators, but not auditors. Bankers and bonding agencies had been lobbied by Non Big-4 audit firms to accept a lower level of assurance (review report or even a notice to reader) instead of asking for a full audit report. The loan size threshold for demanding an audit ranged from $1-$10 million, subject to other conditions such as personal loan guarantees and collateral. All four bankers (and the two bonding agencies) reported facing client resistance to requests for an audit (and its cost); competitive pressures often led them to relaxing their demand for an audit. Bankers thought of auditing services to be a commodity, and any differentiation in audit quality occurred at the partner level within firms and not across firms. Banks did not reduce interest rates for getting an audit. They generally required an audit from companies who were growing and borrowing more funds. Their view was that such growth companies would eventually get lower debt costs as they were preferred clients, so there should be a correlation over time between being audited and lower cost of debt. Bonding agencies also offered pricing discounts based on volume of business, and not for audited financial statements.
Two Non Big-4 audit partners who participated in the study either openly disparaged the value of a (full) audit (one partner), or defended the value of a review engagement and claimed that additional procedures could be undertaken to make the review engagement almost equivalent to an audit. Technically this would violate professional audit standards, but that was not an important consideration. There was a concern that any clients upgrading to an audit might be lost to a Big-4 Firm. Since Big-4 firms compete with Non Big-4 firms for small clients, there is no referral or client transfer mechanism in auditing (as you might find in professions such as law, dentistry or medicine which have a more formalized generalist and specialist hierarchical structure).

Private equity firms and corporate directors responded quite differently to questions about their preferences for auditor. They all wanted a Big-4 audit firm. Private equity firms said that prospective buyers (when they wanted to sell the firm) always accepted numbers audited by a Big-4 firm without any concern. They also believed that Big 4 firms actually were more expert and helped create more accurate financial statements. Directors also wanted a Big-4 firm though they were willing to have a national audit firm as long as the firm had the requisite industry expertise. Only the Big-4 audit firms were automatically thought of as being expert in all industries. All respondents thought there was a lot of variance within audit firms and that the specific partner also mattered a lot to determining the quality of service received. This pattern of responses is consistent with previous findings that companies who access equity markets tend to have Big auditors, whereas clients of Non-Big auditors are mainly reliant on debt financing (Chang et al., [2009]).
4.2. WHO CHOOSES THE AUDITOR AND HOW IS THE CHOICE MADE?

Who chooses the auditor is a central issue that has motivated a lot of research and regulatory attention in the quest to preserve the independence of the auditor. A variety of proposals have been put forward in public markets, such as letting investors or some third party select the auditor (Mayhew and Pike [2004]), though the Sarbanes-Oxley Act (SOX [2002]) assigns the responsibility for auditor selection to the audit committee. Recent focus of the literature has been on whether audit committees actually carry out their legislated mandate effectively (Fiolleau et al., [2013]), and whether management continues to have significant influence over the auditor appointment decision despite attempts made in SOX to minimize such influence (Dhaliwal et al., [2014]).

In private markets, there is no question that the management selects the auditor. In all eleven cases we examined, management (usually the CEO) had the dominant say in choosing the auditor. CFOs and board members also explicitly acknowledged that personal relationships were the key variable in auditor choice. For the most part, the choice of auditor is made based on a pre-existing relationship that a member of management, or the board has with an audit partner. In some cases, another intermediary (e.g., lawyer) gave a recommendation, so the personal network of each audit partner is important in gaining audit engagements. Regardless of who made the introduction, management had the final say in auditor choice.

Unlike public markets, participants in private markets expressed no concerns about independence, possibly because various agents (private equity firms, bankers) can monitor the auditor directly, and hire auditors on a recurring basis so the individual audit partners’ reputation works more effectively as a quality inducing device in private markets for capital. Private equity firms take board seats and can monitor the auditor directly. They receive the auditor’s
management letter indicating internal control deficiencies and recommendations, governance related comments, and errors detected and corrected. Likewise, bankers sometimes request copies of the auditor’s detailed work papers, make queries of the auditor, and ask the auditor to explain their reasoning behind complex accounting estimates.

Private equity firms could easily influence an auditor choice\(^2\) (as could the bankers) but they chose not to do so. These agents take the auditor’s independence for granted, and want management to choose an auditor who they (management) will respect and listen to. Audit partners invest much time and effort developing business networks and prefer to obtain business via people they know and trust. All three directors we interviewed expressed the view that private companies should follow the same governance (best) practices as public companies, and that the board should take the lead in selecting the auditor. The directors did acknowledge though that management should have a significant influence on the auditor choice. However, there was no evidence that the companies on whose boards these directors served (2 of them served on companies in our sample) had actually been actively involved in selecting the auditor. In one case, management (CEO) made a decision to change the auditor (see the discussion of Company 6 below), and then wrote a memo justifying their choice. The board endorsed the choice and voted to appoint the new auditor. We came across only one other case where a board member was on the selection committee, though even on this case the CEO was clearly the dominant decision maker. In seven of our companies there was a board, but we found no case where the board had taken the lead in selecting the auditor.

\(^2\) Most private equity firms buy at least 51% of the outstanding shares. In some cases, where they buy less than 50%, they still buy a substantial ownership stake (30%) that gives them one or more seats on the board and significant influence on corporate decisions.
Directors, private equity firms, and bankers communicate directly (in private) with the auditor. They expect the auditor to be completely candid about any accounting and internal control or governance concerns. Directors were also interested in obtaining the auditors’ assessment of the quality and adequacy of management’s capabilities and controls. A perception that the auditor is less than forthcoming severely undermines their trust and relationship with the auditor. Directors, private equity firms, and bankers perceived wide variance in the communication capabilities of audit partners across all audit firms. Auditor reputations are personal and users had some clear preferences for some partner(s) over others in each audit firm.

All users wanted an auditor to be an accounting expert and understand the industry. CFOs, directors, private equity firms, bankers, and bonding agencies cared deeply about the reliability of accounting data, wanted an expert to proofread all disclosures, and the fact of an independent audit added to their confidence in the financial statements. CFOs wanted accounting assistance, sometimes wanted the auditor to do some accounting work for them, and complained bitterly that the private company auditor was acting like a public company auditor, if the auditor refused to provide direct accounting assistance.

All users also cared about the quality of internal control, wanted the auditor to identify deficiencies, and make suggestions for improving all accounting systems and controls. CFO’s found the mention of a control-related suggestion in the auditors’ management letter to be an effective tool for driving operating and systems changes in their organization. Directors, private equity owners, and sometimes bankers also monitored management to see how responsive they were to auditor suggestions. A CFO who was unresponsive to internal control suggestions was in danger of being fired by the company. Likewise, a CFO who generated too many end-of-year adjustments, or refused to make adjustments suggested by the auditor would be seen as being
incompetent and risked getting fired by the company. The CFO had good reasons to want to manage down the number of adjusting entries presented by the auditor to the board.

All users were receptive to auditors’ business advice. One common response to “What do you want beside an audit report?” was “any advice that can make the company more profitable.” All users wanted an auditor who had good knowledge of the business and could suggest improved business processes that would enhance the profitability of the company. Ability to provide tax and various types of business advice was clearly a positive factor that would favor hiring a specific auditor. All users wanted auditor involvement in reviewing tax compliance, and most were receptive to auditor involvement and providing tax planning suggestions as well. In many cases management (and other employees) desired personal tax planning advice as well. Users were receptive to auditors connecting them to business networks such as sources of capital, customers, regulators, dealings with accounting standards and tax authorities, and various industry surveys and other benchmarks they could use to better run their business. We saw little anxiety about conflict of interest or concerns about knowledge spillovers to competitors.

The desire by all agents (CFOs, private equity, bankers) for auditor advice on internal controls, tax, business processes, and connection to business networks favored hiring an auditor who would get along well with management. Management’s willingness to engage with the auditor, and follow the auditor’s advice, was seen as desirable by all users (directors, private equity firms, bankers, bonding agencies). The auditor was seen as bringing professionalism and sophistication to the business, and the hope was that management and the auditor would develop good chemistry and improve the professionalism and profitability of the company. These considerations led all users to give management a dominant say in choosing the auditor, and especially the CEO. In contrast to debates about directors selecting public company auditors, all
private company directors acknowledged the importance of having management significantly involved in choosing the auditor.

All companies in our sample purchased an array of consulting services. Sometimes even the smallest companies had elaborate tax shelters and subsidiaries set up in various tax havens such as Ireland and Cyprus. Clients of Big-4 audit firms preferred to buy services from their audit firm (one-stop shopping), and desired having a single point of contact (relationship partner) who managed all their service needs in the audit firm. Most CFOs wanted the best expert, regardless of location. This suggests that audit firms may be able to develop regional pools of expertise and deploy them across the firm’s clients. There is less need to develop deep tax and consulting capabilities in all local markets. Clients of Non Big-4 firms tended to purchase tax expertise from lawyers, again possibly suggesting reluctance on the part of Non Big-4 firms in having their clients being involved with competing Big-4 audit firms.

4.2.1 The Request for Proposal [RFP] Process in Private Companies.

Fee is the final consideration in hiring an auditor. There was a widespread feeling that there is little or no difference in quality of service across all audit firms. Commoditization of auditing combined with a recession created pressure on audit pricing.³ The general view across all respondents was that putting the audit out for proposal (RFP) was an effective device for lowering the audit fee, though some worried that it had only a short term effect and was not worth doing. Auditors we interviewed did not like RFPs and preferred to do business in the traditional way by developing personal relationships with senior managers and/or corporate

³ Similar pricing and discount opportunities were thought to be present more generally in the market for business professionals, such as lawyers. However, auditors were generally seen as being more amenable to pricing pressure and offered larger price discounts than lawyers.
directors. The frequency of RFP’s is increasing as companies seek to reduce audit fees and/or see tendering as an effective governance process. All three directors in our sample expressed a preference for periodic tendering of the audit as a good governance process. The CFOs in our sample tended to view tendering as a mechanism for lowering audit fees. For the most part, audit firms felt compelled to respond to such RFPs to maintain their relationships with key CFOs and directors in their local market.

In our sample, four companies had gone through an RFP process to select their auditor. We provide a summary of key facets of this process in Table 2. The incumbent Big-4 auditor managed to save the audit relationship and got re-appointed as the auditor in Company 1, an auditor change occurred from a Non Big-4 firm to a Big-4 firm in Company 4, and a switch from one Big-4 firm to another Big-4 firm occurred in Company 6. An auditor change occurred from a Big-4 firm to a Non Big-4 firm in Company 10.

Company 1 had a significant poorly run and poorly performing subsidiary. A decision was made to invest significant amounts of additional capital, improve internal controls and improve financial expertise of management. Despite these changes, the audit firm (Big-4 Firm A) continued to increase its fee, rotated a partner off this client and brought in a younger partner, and had poor staff continuity. The President decided to do an RFP to significantly reduce the audit fee, and send a signal to the auditor that it was not being responsive to the business and its changing environment.

Three Big-4 firms [A, B and C] bid on this audit offering prices ranging from 40% to 76 % of the preceding year’s fee. The information acquisition process was quite idiosyncratic. The president was a one person committee for choosing the auditor (with no board involvement), and
provided information privately to each prospective auditor depending on his perception of the partner proposed by each audit firm. If the president liked the proposed partner, he made himself available and was very forthcoming in explaining what the last year’s fee was, the service issues, and where the previous auditor did the bulk of their audit work. If he did not like the proposed partner, he did not make himself available and let the partner talk to the newly hired controller of the company.

In a field study of public company RFPs, Fiolleau et al., [2013] report that auditors in a RFP usually expect the incumbent to bid the same fee as the preceding year. The incumbent [Big-4 firm A] however knew they would lose this client if they followed that script, and this company was part of a very large business group that was a significant client of the audit firm. The incumbent guessed correctly that its main competitor [Firm B] would bid about 75% of last year’s fee (given the structural improvements in the company) and so first set a bid at 75% of last year’s fee, and then offered a special discount to get the fee down to 57% of last year’s fee. A previous partner and manager, who were liked by management were assigned to this engagement, and assurances were provided on staff continuity. One Big-4 competitor (Firm C, who had received the least information from the company) offered a bid of 40% of last year’s fee, but this was deemed to be too low and not a serious bid. Since the president did not like the proposed partner, no bid from this audit firm was likely to have been accepted.

In Company 4, management wanted a Big-4 firm because they wanted to sell equity in the firm. Two of the bidders (Big-4 firms C and D) had personal ties with at least one director, and the CFO was an alumnus of firm C, so the selection was narrowed down to Firms C and D. Even though relationships favored Firm C, the lowest bid came from Firm D. Firm C was given a second chance to revise their bid and urged to “sharpen their pencil” and come up with a lower
bid. Firm C did not lower their bid much but provided some “free” consulting hours in their audit fee. Despite the relationship strength, management chose the lowest cost bid, and Big-4 Firm D was appointed as the new auditor. The CFO thought the audit was a commodity and despite his personal preference for Firm C, he could not justify advising the CEO to pay more for an auditor.

In Company 6, the RFP arose from the client’s dissatisfaction with the quality of service provided by the incumbent Big-4 Firm (Auditor D) due to some late adjustments made to the financial statements in the previous year, and a feeling that the auditor did not ‘fit’ with management, because they did not see the business the way management did. The managing partner of a competing Big-4 Firm (Firm A) had been developing a relationship with the CEO of Company 6, and that helped induce the company to issue a RFP.

Even though this firm appeared to follow a systematic process, and submitted a justification memo to the board at the end, it was clear that the relationship between the dominant decision maker in the company (the CEO) and the managing partner of Firm A trumped all other considerations. Firm A brought their national CEO to meet management (which made management feel special), and invited management to some industry related conferences in Toronto. Management felt that Firm A liked them, wanted their business, and shared their way of thinking.

Firm A was appointed as the new auditor even though it was the highest bidder on this RFP. One interesting twist was that Firm A had bundled in some “free” consulting hours in their audit fee. Management and the board were keen to take advantage of all the “free” hours provided as part of the audit fee. The auditor of this private firm, without need for pre-approval from an audit

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4 The hours can be used anywhere from seeking accounting and audit assistance, tax advice, or more general consulting services.
committee and no disclosure requirement, bundles the fees for audit and consulting services into a single amount labeled audit fee. Officially, the client paid no consulting fee. Management claimed to be extremely pleased with their new auditor (Firm A) and had subsequently sought advice on several major finance related issues from the auditor.

In Company 10, the bank asked for an audit and the management looked for the lowest bid. Again there was no board involvement. The process was straightforward, and the lowest bidder (a national firm) who bid 50% of last year’s fee was appointed as the new auditor.

On three out of the four RFPs, there was a substantial reduction in audit fees and most CFOs asked for a 3 year quote to keep them from rising after the engagement. CFOs believed that one consequence of putting the audit out for tender is a significantly lower audit fee. Despite the appearance of going through a public company like process, the pre-existing relationship between management and the audit partner had a major impact on the auditor selection process. The RFP process had one clearly dominant decision maker in all cases. In the study of public company RFP process (Fiolleau et al., [2013]), the audit partner spent a lot of time trying to identify who the key decision maker was (rather than assessing the quality of internal controls, risks, or unadjusted errors). In the private audit market, it was much clearer who the key decision maker was, and the partner could concentrate on understanding risks, controls, and need for business services. Lack of accounting/audit related expertise differentiation meant a lower fee, pre-existing client relationship, or provision of non-audit services were major determinants of which auditor got hired.

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4.3. HOW IS AUDIT QUALITY ASSESSED?

The overwhelming criterion for assessing audit quality was the quality of the output of the accounting system, namely the quality and reliability of the financial statements. CFOs and users of financial statements were not just paying a fee to buy a piece of paper (an audit report). They cared deeply that a real effective audit is performed at a reasonable price, and they thought of the audit as providing significant protection and comfort to them personally as they carried out their duties.

The first opportunity to assess audit quality is in the review of the audit plan. According to audit standards (PCAOB Auditing Standard No. 9 [2010]), audit planning judgments (audit hours, risk assessments, staffing, timing) are made by the auditor to bring the risk of audit failure down to an acceptable level. However, in practice these judgments are not made by the auditor alone, they are made in consultation with the CFO and reviewed/approved by the board. CFOs treated the external auditor as if he were a part of the company’s internal (or their personal) control system and it was natural to let the auditor know where (s)he wanted more testing to be done, what staff to assign to the audit, and when necessary, even ask for the partner to be replaced in absence of a “fit” with the CFO. Likewise, all directors reported that they examined the audit plan and wanted to feel comfortable with the number of audit hours, the risk assessments made, and staffing decisions. The idea that the auditor should be allowed as an independent agent to decide where (s)he wants to do testing and might even be unpredictable as to place or timing was deemed to be completely unacceptable. “They have to be told where to do the testing” a director said. An auditor whose risk assessment did not conform to the CFO and board members views of where the key risks were and where the major audit effort should be allocated, was deemed to be incompetent.
The CFO and directors treated the external auditor as though he was part of their (internal) control system, and his job was to protect them from the risks they perceived to be in the company. These risks were not from fraud (which would require a more strategic and unpredictable auditor), but from errors arising from limited accounting competence of staff and internal controls. The auditor had to conform to CFO and director expectations. An auditor who did testing not deemed to be in the relevant risk area would be unacceptable, and the audit firm would be changed, or the audit firm would be asked to assign a different partner. With respect to materiality, CFOs and directors reviewed audit hours and an auditor whose hours looked too low would be deemed not to have done an adequate audit, whereas one whose hours were deemed too high would be suspected of overcharging on the audit fee. CFOs and directors understood that the audit fee was a contracted price, but still felt there was a strong relationship between audit hours and the total audit fee. CFOs and directors were thus keen to know the auditors hourly rate for each grade of expertise. Some CFOs reported having asked for a new partner on multiple occasions if the partner was deemed not to “fit” their views of a proper auditor. Audit firms always obliged companies who requested a change in partner.

A second facet of assessing audit quality came from the accounting policies, disclosures, and adjusting journal entries made at year end. CFOs and directors wanted the auditor to be an accounting expert, to be available 24/7, be very responsive, the numbers and disclosures to be accurate, and presentation to be at best practice. Any error in a number or disclosure would be embarrassing for the CFO and the directors, and would undermine their faith in the auditor. The auditor is supposed to catch such errors before financial statements are released. Finally, CFOs and directors monitored the number of adjusting journal entries at the year end. Since these agents, as well as bankers, bonding agencies, and private equity funds make decisions based on
periodic reports produced by the company, they did not like big surprises at the year end. The audit was supposed to confirm the accuracy of previous reports produced by the company (Demski and Feltham [1994]). Large adjusting entries at year end undermined faith in the competence of the CFO, as well as the auditor. A good auditor would be proactive, make timely adjustments, and provide advance warnings about any forthcoming problems, without waiting till the end to ask for adjustments. Again this requires frequent engagement between the auditor and CFO, and possibly the board as well.

A third facet of audit quality was the advice provided on improving internal controls, tax and other business processes. The CFO, directors, private equity firms, and sometimes even bankers read the auditors management report and were keen to know the auditors’ views on improving controls, governance, staff capabilities, and general business process improvements. Recommendations on controls had to pass a “practicality” test and be operational, and not just be a recitation of textbook issues that could not actually be implemented. Likewise, when the auditor was asked a question about what accounting standards to use (choice available is between a Canadian Private company GAAP called ASPE, or IFRS) the response had to seem tailored to this company, and not just be a generic preference for IFRS. Most CFOs and board members preferred the use of ASPE for private companies, with a preference for IFRS only if the company was planning to go public, or wanted to be taken over by a public company. CFOs and directors strive to assess how much of the advice they are getting is really tailored and relevant to them, and how much is just some boilerplate content. They also want their preferences of GAAP to be consistent with those of their auditor (See also Jamal and Tan [2010] regarding the importance of congruence between GAAP choice and the auditor’s mindset).
In addition, the auditor had to provide business process advice. It was not sufficient to limit recommendations only to accounting and control issues. The auditor had to show a real understanding of the business and provide advice on how to run it better, and make it more profitable. For tax advice, directors preferred the audit firm to be a bit conservative, and not to pitch very aggressive tax schemes.

CFOs, directors, and private equity firms were interested in business networks that auditors might open for them ranging from connecting them with other companies in the industry, potential customers, other sources of capital, ideas, and industry benchmarks. Keeping them out of trouble with the tax authority was also important. In the event of a tax problem, they wanted the audit firm working actively on their side. These networking opportunities created a more intangible sense that the “auditor is thinking about our business,” the auditor likes us, and is committed to help us succeed.

4.4. USE OF ACCOUNTING NUMBERS IN DECISION MODELS

4.4.1 Private Equity Firms. Private equity firms described a five part decision making process. The first step was to obtain and review audited financial statements as well as management’s projections of cash flows for the next 5 years.

Second, the operating assumptions underlying the cash flow projections would be tested as part of the due diligence process. For example, if the target company was in construction, the order book would be examined to support future cash flow projections. If a company had office buildings, the contracts of the tenants and credit ratings of tenants would be examined to assess future cash flows. If a company reported intellectual property on the balance sheet, the employee contracts would be examined; they would not just accept the auditor’s judgment that this was a
company owned asset. For revenue recognition, a construction accounting expert would be hired to check the current contracts and cash flows of the firm, and to assess how appropriately (or conservatively/aggressively) the revenue had been recognized. Even though the financial statements are audited, individual accounts on which significant reliance was going to be placed (such as revenue) would be examined in more detail. A balance sheet stress test would be conducted and an assessment would be made of how much of the purchase price would be allocated to specific assets versus goodwill.

Third, a “Quality of Earnings Assessment” would be performed. This earnings assessment could be done in-house, or if the deal was going to have substantial bank financing, a corporate finance unit of a Big-4 firm would be hired to do this analysis. The focus of this analysis is to estimate the sustainable cash flows expected from this business available to pay off debt and taxes (earnings before interest, depreciation, tax and amortization – or EBITDA). The sales growth estimates provided by management would be used to calculate estimated EBITDA for the next 5 years. Then a series of adjustments would be made to calculate a normalized EBITDA. The adjustments would be for tax shields, related party transactions adjusted to fair market value (e.g., royalties, rent, land, buildings, equipment), management compensation might be motivated by tax so it would be adjusted to fair market value, goodwill, R&D, capital structure, and capital expenditures needed. In addition, some working capital items may be written off (e.g., Accounts receivables older than 90 days may be partially or completely written off even though the auditor did not require a write-off). This would then lead to a set of normalized EDITDA values for 5 years that would be used to price the company. Even though the people performing the quality of earnings analysis had strong accounting backgrounds, the analysis focused on cash flows and dispensed with accounting accruals.
Fourth, management quality would be assessed. In addition to discussions with management and examining various internal plans and documents, references would be checked; the top 5 customers would be visited and observed as they interacted with management; customers would be asked about why they do business with this company, how a change in ownership might affect them, and which employees were critical to maintain continuity of business. Generally private equity companies are reluctant to change top operating personnel (want them to stay and have some ownership interest), though they are more willing to make changes in finance and other support operations.

Fifth, the private equity firm would require the company to have a board, and would then take control of the board. This would give them access to the auditor; and they would clean out insiders and appoint outsiders who help connect the company to important constituencies such as key customers, suppliers, or government officials. The private equity firm may want subsequent mergers with other companies as they strive to grow the business, and the company would immediately be put in “deal readiness” mode (data room, key financial indicators, and various schedules) so a deal can be consummated quickly if a suitor comes along with an attractive offer for the company.

The receipt of audited financial statements is the first step in a due diligence process. There is no functional fixation on accounting numbers. Most analysis focuses on cash flows. When extensive reliance is going to be placed on accounting numbers (e.g., revenue) an additional expert (including another Big-4 audit firm) would be hired to examine the underlying quality (conservatism) of the accounting process. Limited reliance is placed on the audit.
4.4.2 Bankers. Bank lending and credit ratings have been the focus of the bulk of accounting research on unregulated demand for accounting and auditing. Banks use accounting numbers in debt covenants (we observe limits on cash flow coverage, tangible net worth, debt to tangible net worth, current ratio, management remuneration, capital expenditures including leases, and require the creditor to carry insurance, file and pay taxes, comply with environmental laws, and not to sell certain assets). Banks also expressly reserve the right to re-negotiate or adjust covenants in response to any change in GAAP that affects calculations of covenants.

Banks also require companies to submit extensive financial information so the client company can be monitored continually. Benchmarking a company against its past record, as well as other companies in its industry, is a key monitoring mechanism. Banks require client companies to provide a series of monthly reports (which could include financial statements as well as aged listings of receivables, payables, and inventory), quarterly financial statements, and annual audited (or reviewed) financial statements. Companies are also required to submit an annual business plan, pro-forma balance sheets, income statements, and cash flow statements, as well as capital expenditure forecasts for the current fiscal year, showing purpose and source of financing.

Banks rate the risk of their clients. The bulk of the weight (about 65% on average for our firms) of risk rating is on financial performance, an average of 10% is on industry conditions (including concentration/diversification of the company’s products and customers), an average of 10% is on assessment of management quality (which is based on interviews of management, education credentials, depth and breadth of management, succession plans, internal control, and governance), about 10% on capital risk (and items such as guarantees, collateral), and 5% is on idiosyncratic risks that could materially alter the company’s performance. Each of these
variables is assessed based on a series of questions, some of which require qualitative responses. Some of these subjective items may have non-linear weights in that an idiosyncratic risk could drive the overall risk rating in a non-linear way if it is qualitatively significant.

Governance is assessed based on existence of a board and its powers. Bankers like to see two sub-committees, an audit committee and a corporate planning committee (focusing on strategy and operations with oversight of capital expenditures). They like to see some accounting expertise on the audit committee. Background checks are done on audit committee members, so if a director of a public company has been involved in a scandal, then their impaired reputation in the public market will hurt them in the private market as well.

The financial performance variable is assessed based on profitability (sales growth, gross margins), liquidity (current ratio), the amount of investment, leverage (tangible net worth, total liabilities/EBITDA), capital expenditures, and cash flows (EBITDA). Prior to calculating inputs for their models, Banks have a specialist data entry department who make a series of adjustments to accounting data (for leases, related party transactions, taxes, and they may write-off receivables or inventory older than 60 days even if the auditor allowed the company to carry them as assets on the audited financial statements). Ratios are calculated based on these adjusted accounting numbers. Having a specialist data entry department develops expertise and consistency in data entry. It also reduces the possibility of loan officers entering biased numbers into the bank risk models to favor the companies in their portfolios. There were frequent mentions of EBITDA as a key measure suggesting that certain accounting items like depreciation, amortization, interest, and taxes were routinely adjusted for before financial numbers were used in decision making.
Bankers mentioned the importance of having clarity in the notes to the financial statements, and the need for consistency in application of GAAP. They were keen to know if there had been any change in the way a client company implemented GAAP. Changes in assumptions, discount rates and other estimates were of interest to them. If the loan amount was large, bankers would ask to see the auditor’s management report, and might even ask for an annual meeting with the audit partner or manager.

Benchmarking and accounting consistency were the key variables. Bankers expressed some concern that IFRS was “too loose” and allowed too much judgment. There was no weight in their model for quality of accounting, quality of auditor, or any direct accounting variables. Bankers expressed some concern that accounting was too complex, not very useful, and provided just one input among many. They were not comfortable rating the quality of accounting of any company, and thought that speaking about accounting quality was too difficult given how “loose” IFRS standards are. Accounting data were adjusted (leases are mentioned explicitly in one of their adjustment schedules) and we observed no functional fixation. Benchmarking and looking for consistency of financial and non-financial data were the main monitoring mechanisms used by bankers.

4.4.3 Bonding Agencies. The bonding agencies [surety companies] in our study were subsidiaries of insurance companies who primarily provided bonding coverage to construction companies though they had other clients as well. The main risk to these agencies is that a bank refuses to renew a loan for a construction company, and the construction company cannot complete a bonded contract.
Bonding agencies also were keen followers of benchmarking, reviewed the company’s compliance with debt covenants (the auditor also reviews such compliance), and adjusted accounting numbers before calculating ratios. They had a section in their schedule called “non-allowable assets” which excluded all goodwill, patents, incorporation costs, R&D, and related party assets. The schedule also had a section with a heading of “adjusting current assets” where accounts receivables, inventories, marketable securities, and other receivables on the financial statements could either be deleted or a portion could be written off. Likewise, related party transactions could be adjusted in whole or in part. There were explicit headings for tax shields and management bonuses to be adjusted, though the bonding agencies seemed to have considerably less financial expertise than the bankers, and it was not clear how many adjustments were actually made.

Bonding agencies seemed to be placing a much higher weight on industry conditions. If a company in a specific sub-sector of the construction market failed and a payout had to be made, then a risk revision took place for other clients in that sub-sector. The bonding company was more likely to deny coverage to all companies in a specific sub-sector if losses were incurred, even if a specific client appeared to be at an acceptable risk level. In comparison, auditors’ and bankers placed less weight on broad industry conditions. Bankers seemed reluctant to lose clients even when the clients had company specific risk factors.

4.4.4 Directors. All three directors we interviewed were distinguished Chartered Accountants who have served as CEO’s of various companies, and currently serve on boards of both publicly traded and private companies. They all would easily qualify as being “financial experts” for governance purposes. All directors claimed that being on a board of private and public companies was different, yet all professed that the governance practices of publicly traded
companies were ‘best practices,” and that private companies also should be governed like public companies.

The directors, however, acknowledged that they tended to get much more “hands on” involved in analyzing the operations of private companies than they do in public companies. They try to understand the cost structure and profitability of the company at a detailed level (by product line, geographic location), cash flow generated from operations (and especially monitor receivables and inventory), and capital requirements/leverage of the business. They seem to be using a return on investment type metric, though returns were thought of in terms of operating cash flows.

All three directors commented that accounting numbers and disclosures were becoming more complicated over time, were harder to understand, and were obscuring what was really going on in the company. Changes in presentation mode of accounting numbers (e.g., direct vs. indirect method of cash flow presentation) were seen as being irritating, even though numbers in one format can be re-classified into the other format. Over time, accounting was becoming less useful to them in understanding and carrying out their role as directors.

All directors asked the CFO to recast the financial statements into a form they could use and focus more on understanding operating cash flows and the key metrics that management uses to operate the company. They tended to ignore accounting accruals as much as possible, though they all acknowledged that they would have to pay much more attention to accounting numbers and disclosures when they serve on boards of publicly traded companies. They also preferred the Canadian Private Company GAAP (ASPE) over IFRS, though they were open to using IFRS if the company was planning to go public, or be bought by a public company.
The complaints about GAAP by this elite group of directors (and similar complaints by bankers, and the dominant focus on EBITDA in various versions by private equity) mirror the inconvenient truths about GAAP raised by Palmrose [2009] who claims that GAAP is broken, not based on general acceptance or understanding, that accounting is evolving in a manner where increasing complexity of GAAP makes it harder for users to understand the company, and that companies cannot participate meaningfully in standard setting activity (see also Jamal and Sunder [2014] on poor participation by the accounting community in standard setting activities relative to other professions such as engineering). Fair value estimates in GAAP reduce the “hardness” of accounting numbers and thus willingness of users to rely on accounting for contracting purposes. GAAP also does not capture intangible assets well (Srivastava [2014]), thus causing private equity firms to rely on other experts to verify intellectual property and other such assets. As GAAP becomes less useful to users, so does the audit.

5. Summary and Implications for Public Regulation of Auditing

This study investigates why private companies hire auditors, and how they go about doing so. We also investigate user perspectives of auditors, and how the financial statements are combined with non-financial information to make decisions. A field study was conducted to gather interview data as well as primary documents from CFOs, auditors, bankers, private equity firms, bonding agencies, and corporate directors.

Our results indicate that demand for private audits comes from a much wider set of agents than those studied in the accounting literature. Desire to access debt and/or equity capital
dominate the demand for audit, though customers, suppliers, internal governance demands, and other regulators also seek audited financial statements for private companies.

In private companies, management selects the auditor, and companies seeking to access equity markets prefer Big-4 auditors, whereas companies seeking access to debt capital are indifferent as to audit firm size. Management and all user groups want the auditor to be a business advisor and provide tax, internal control, and business services that help the company operate more efficiently and become more profitable. Regulators have sought to counteract these incentives by getting the audit committee to hire the auditor for public companies (now required by SOX), press companies to hire a broader set of audit firms (not just Big-4 audit firms), and restrict the set of consulting services that auditors can offer (and discourage companies from procuring allowed consulting services with audit committee approval processes and disclosure requirements – also required by SOX). There is no evidence that regulators have been successful in counteracting these underlying private incentives (see Dhaliwal et al [2014] on continuing management influence in selecting public company auditors), and there is reason to doubt whether restricting consulting services serves shareholders (Kinney et al., [2004]).

More recently, regulators have sought to force audit firm rotation and or require the audit committee to put the audit out for tender (i.e., RFP). This is being promoted as a mechanism for enhancing independence of the auditor. Field observations suggest that, instead of promoting independence, audit firm rotation will only serve to drive down the audit fees as undifferentiated audit firms vie for customers by reducing fees, offering consulting services or building client relationships. Fiolleau et. al., [2013] find that the process of going to RFP for public companies promotes fee and opinion shopping and requires prospective auditors to demonstrate
commitment to management. Tendering the audit is thus likely to reduce independence and audit quality, rather than enhance it.

In private markets, CFOs and corporate directors treat external auditors as part of their (internal and almost personal) control system. Almost all elements of audit planning (audit hours, risk assessments, staffing, timing and location of procedures) are subject to discussion with the CFO and need to meet the expectations of CFOs and corporate directors as to proper focus and scope of the audit. This system of auditing is oriented to detecting error, not fraud. There is no interest in fraud detection per se, and there is almost no randomness/unpredictability in the auditors’ work. Surprisingly, regulators have carried over this feature of private auditing into the public market. In public companies, external auditors are required to submit their detailed audit plans for review and approval of the audit committee (PCAOB Auditing Standard No. 16 [2012]). There is virtually no scope for a public company auditor to surprise management and disrupt a fraud. It is therefore not surprising that external auditors are seldom the agent who detects a fraud (Dyck et. al. [2010]). This does raise a question as to why regulators want to preserve this feature of private audit markets even as they claim an interest in improving the effectiveness of the external auditor in detecting fraud.

Users of audited financial statements in private markets have access to extensive private information about the quality of internal control, governance processes of companies, capabilities of management and the audit partner/manager. Users also hire additional experts to verify key numbers they intend to rely on (no functional fixation), and make adjustments for known deficiencies of accounting (e.g., add lease payments back as debt) and audited financial statements (e.g., adjust for biases due to tax considerations, related party transactions, and non-cash items that have large managerial opportunity for manipulation such as impairments,
depreciation, amortization, and goodwill). The more troubling finding is that even expert users find GAAP financial statements to be more complex and less useful over time, and seek to avoid using accounting measures by focusing on simpler cash flow measures. In public markets, investors have less access to information about the quality of internal control (just a pass/fail report), internal governance processes, and less ability to know the quality of accounting estimates made by management.

The portfolio of services provided by firms to their audit clients often includes a broad range of non-audit services. Accounting, tax preparation and review, information technology, market research, hiring, business strategy, networking, regulatory guidance, and improving efficiency of operations are some of the frequently seen elements in business advisory services. Pursuit of auditor independence in the public domain has motivated regulators to view such advisory services provided by auditors to their clients with a degree of suspicion. The general direction of public policy has been to try to minimize the conflict of interest the auditors face by restricting or eliminating the provision of such advisory services to the audit clients. These efforts have met with stiff resistance from audit firms, and limited success in the field.

Absent such regulatory pressures, provision of advisory services to private clients appears to be even more tightly bound to audit services. Bundling of audit and non-audit services appears to be a norm, not an exception. If provision of advisory services to audit clients creates serious conflicts of interest for auditors, why would their clients want the bundled services? Recall that these clients voluntarily pay for the audit and go to some lengths to ensure that they receive audit services of high quality. It may be possible that the information advantages of bundling various services from a single vendor may exceed the disadvantages of conflict of interest as argued by Zhang (2004). While no theoretical issue of this nature can be settled by a single field study,
these results do raise interesting questions about the efficacy of pursuit of auditor independence by separating the provision of audit and non-audit services. It seems possible that the cost of such policy may exceed the benefits, but more work is needed to establish such a proposition.

Section 401 of the JOBS Act of 2012 in the U.S. expanded the exemptions from “small issues” security offering registration under Regulation A of the Securities Act of 1933. This relaxation applies to offerings no larger than $50 million (compared to $5 million under Regulation A). Unlike the Regulation A requirements, issuers under Section 401 are required to submit audited financial statements on an annual basis after completion of the offering (we do not yet know if, when the SEC rule making is completed, these issuers will be required to file audited financial statements as part of the offering statement).

A comparison of provisions of audited financial reports by (1) private firms, (2) firms under Regulation A, (3) the new Section 401 exemptions, and (4) the traditional public firms that provide Form S-1 registration statements with the SEC, focuses attention on the problem of balancing the time and expense of auditing against the level of protection available to investors. As we have seen in the present study, private firms readily provide credible audited financial reports when the potential sources of equity and debt capital demand them. Addition of a regulatory requirement to provide such reports would do little to promote capital formation in such firms. At the other end of the spectrum, the public firms (Form S-1 registration with the SEC).

5 Sorkin (April 2, 2012) in his The New York Times column captured this tension: “Its goal is noble: start-ups and small businesses are the lifeblood of our economy, and it is hard to argue with helping entrepreneurs build businesses and hire employees. However, the legislation, in the name of creating jobs, dismantles some of the most basic protections for the most susceptible investors apt to be drawn into get-rich-quick scams and too-good-to-be-true investment “opportunities.” Also see Taibbi (2012).
SEC) are required to furnish audited financial reports when they offer securities, and periodically thereafter. There is no known evidence that, had this regulatory requirement not been imposed by the securities laws of 1933, the frequency and quality of audits of public firms would have been lower or higher, and the volume of capital formation in this sector of the economy would have been different, than what prevails at the present. As Benston [1969] reported, 82 percent of publicly traded firms already issued audited financial reports before the 1930s. PCAOB’s (in the U.S.) and CPAB’s (in Canada) reports on the quality of audit provided in the recent decade provide little reason to believe that the quality of auditing has improved in the intervening eight decades. For both these reasons, it is unclear that regulatory audit requirement has made a positive contribution to capital formation.

What can we say about auditing and capital formation in the two intermediate categories of Regulation A firms (closer to private firms with no regulatory audit requirement) and Section 401 firms (closer to publicly traded firms with at least periodic audit requirement after securities are issued)? At this time, we do not know how many of these firms will voluntarily hire an auditor though it is likely that many of them will do so even without being required to do so by law. Law is not the only consideration driving the demand for audit. Additional field and survey research is needed to assess the cost-benefit balance of regulatory audit in various size-based segments of the economy.

A field study has both advantages as well as limitations. The sample size is small and most of the data is qualitative. Even though our participants are all highly involved in business, highly expert, and were very forthcoming, we still have only a small sample of interviews with CFOs, auditors, bankers, private equity firms, bonding agencies, and corporate directors. These participants may not be representative of their respective groups. Assuming they tell us truthfully
what they believe, their beliefs may only be loosely related to what they actually do. Future studies can collect larger sample sizes of observations on each of these preparer and user groups. It is possible that participants tell us what is socially acceptable and not their true beliefs, though this possible bias is tempered by having access to primary documents that help verify the comments made in interviews. On the other side, the richness of insight gained from direct interviews with expert participants, and examination of primary documents, bring new facts, motives, reasons and interconnections to light. Such direct observations in the field will aid theory development and better understanding of the economic incentives underlying demand for audit. With these strengths and weaknesses, field studies add a useful dimension missing in more popular research methods.
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APPENDIX 1

Sources of Data

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<td>• None</td>
</tr>
<tr>
<td>CFOs</td>
<td>11</td>
<td>• One Request For Audit Proposal document (RFP) prepared by Company 1</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• One summary prepared by Company 6 for the board explaining auditor choice after conducting a RFP</td>
</tr>
<tr>
<td>Auditors</td>
<td>5</td>
<td>• Three audit bids submitted by Big-4 firms A, B and C in response to the RFP issued by Company 1</td>
</tr>
<tr>
<td>Total</td>
<td>27</td>
<td></td>
</tr>
</tbody>
</table>
APPENDIX 2

Question Script for Discussion with Non-Auditor Participants

1. Industry:
2. Who owns the company? What is the ownership structure of the company?
3. Corporate structure (# of legal entities) / operates in:
4. Size in assets: ; sales ; employees
5. CFO Background / ties to auditor? / been here since :
6. Who is the auditor? For how long?
7. How did you select auditor?
8. Time series of audit fees since hired (if possible)?
9. Who are users of F/S? (Bank, Board [insiders, outsiders], suppliers, customers, bank, employees, tax, regulators, governments, internal decision making)
10. What do they do with the F/S?
11. What do you want from auditor besides an audit opinion?
12. What other services do you buy from the auditor?
13. Rate the importance of each of the following factors in how you assess the desirability of an auditor. 1=unimportant, 5=very important. Fees (1-5), quality (1-5), responsiveness (1-5), knowledge of the industry (1-5), Business and government network (1-5), advisory services (1-5), familiarity (1-5), etc.
14. How do you judge responsiveness of the auditor?
15. How do you judge audit quality?
16. Effect of auditor on accounting policies / tax/ internal control
17. Do you care where the auditor allocates effort (how /where they assess risk?)
18. Do you care what level of staff take part in the audit? Or just continuity? Or just continuity of the manager?
19. If partner has to rotate off, what would you look for in the next partner?
### TABLE 1

**Background of Companies in Private Audit Study**

**Panel A: Companies Audited by Big 4 Audit Firm**

<table>
<thead>
<tr>
<th>Company</th>
<th>Dominant User of Audit</th>
<th>Has Board of Directors</th>
<th>Chose Auditor Using RFP</th>
<th>Sales ($)</th>
<th>Dominant Decision-Maker</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Other Regulator</td>
<td>Yes</td>
<td>Yes</td>
<td>Part of $2 Billion Company</td>
<td>President</td>
</tr>
<tr>
<td>2</td>
<td>Equity</td>
<td>Yes</td>
<td>No</td>
<td>400 million</td>
<td>CEO</td>
</tr>
<tr>
<td>3</td>
<td>Bank</td>
<td>Yes</td>
<td>No</td>
<td>50 million</td>
<td>CEO</td>
</tr>
<tr>
<td>4</td>
<td>Equity</td>
<td>Yes</td>
<td>Yes</td>
<td>200 million</td>
<td>CEO</td>
</tr>
<tr>
<td>5</td>
<td>Equity</td>
<td>Yes</td>
<td>No</td>
<td>60 million</td>
<td>CFO</td>
</tr>
<tr>
<td>6</td>
<td>Equity</td>
<td>Yes</td>
<td>Yes</td>
<td>590 million</td>
<td>CEO</td>
</tr>
</tbody>
</table>

**Panel B: Companies Audited by Non-Big 4 Audit Firm**

<table>
<thead>
<tr>
<th>Company</th>
<th>Dominant User of Audit</th>
<th>Has Board of Directors</th>
<th>Chose Auditor Using RFP</th>
<th>Sales ($)</th>
<th>Dominant Decision-Maker</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Customer</td>
<td>No</td>
<td>No</td>
<td>11 million</td>
<td>CEO</td>
</tr>
<tr>
<td>8</td>
<td>Bank</td>
<td>Yes</td>
<td>No</td>
<td>220 million</td>
<td>CEO</td>
</tr>
<tr>
<td>9</td>
<td>Bank</td>
<td>No</td>
<td>No</td>
<td>15 million</td>
<td>CEO</td>
</tr>
<tr>
<td>10</td>
<td>Bank</td>
<td>Yes</td>
<td>Yes</td>
<td>300 million</td>
<td>CFO</td>
</tr>
<tr>
<td>11</td>
<td>Bank</td>
<td>No</td>
<td>No</td>
<td>11 million</td>
<td>CEO</td>
</tr>
</tbody>
</table>
### TABLE 2

Summary of Request For Proposal [RFP] Processes for Selecting a Private Company Auditor

<table>
<thead>
<tr>
<th>Incumbent Auditor</th>
<th>Company 1</th>
<th>Company 4</th>
<th>Company 6</th>
<th>Company 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Auditor</td>
<td>Big 4 Firm A</td>
<td>Non-Big 4 Firm</td>
<td>Big 4 Firm D</td>
<td>Big 4 Firm D</td>
</tr>
</tbody>
</table>

|------------------|---------------------------------|--------------------------------|--------------------------------|------------------------------------------|
| • Want a substantially lower fee (had made major injection of capital, improved internal control, and hired more a capable Controller)  
• Want a partner with more stature | • Want Big 4 auditor to prepare company for sale to private equity firm  
• Get best auditor | • Lack of fit with current auditor (D)  
- They don’t think about the business the way management does  
- Had last minute adjustment to financial statements (surprise)  
• Management was being solicited by Big 4 Firm A’s office managing partner  
• Get best auditor | • Want low fee (concluded that audit doesn’t provide much value) |

| Who is invited to Bid on RFP | • All Big 4 Firms [A,B,C,D]  
• One non-Big 4 [local firm] | • 3 Big 4 Firms [A,C,D]  
• Didn’t like Big 4 Firm B – thought they would bid low and then extra-bill | • All Big 4 Firms [A,B,C,D] | • 2 Big 4 Firms [C,D]  
• 3 National firms |

| Firms who Bid | • 3 Big 4 Firms [A,B,C] bid – all had ties with the President  
• Big 4 Firm D did not bid because they thought this RFP was just to reduce the fee and would go to the incumbent  
• Local Firm did not bid because they thought they lacked the industry expertise needed to audit this client | • 3 Big 4 Firms [A,C,D]  
• A had no ties to Management or the Board  
• C had ties to a director and the CFO was an alumni of Big 4 Firm C  
• D had ties with a director | • All Big 4 Firms [A,B,C,D]  
• Firm A courted the CEO  
• Firms B,C,D courted directors | • 2 Big 4 Firms [C, D]  
• 3 National Firms  
• One National Firm did a lot of consulting work for the company but did not get chosen to be auditor |

| Fees | • Incumbent Big 4 Firm A Bid 57% of last year’s audit fee in a 2 step process where they first bid 75% of last year, and then gave a special discount bringing the fee down to 57%  
• Big 4 Firm B bid 76% of last year’s fee  
• Big 4 Firm C bid 40% of last year’s fee | • Big 4 Firm A was the highest bidder and deemed not to be too enthusiastic  
• Narrowed down choice to C and D  
• C bid was 62.5% higher than D’s bid | • Big 4 Firm A was highest bidder but had bundled “free consulting” hours into the audit fee (no other firm had bundled consulting with audit) | • One National Firm bid 50% of last year’s audit fee so they were the lowest bidder |

(Continued)
<table>
<thead>
<tr>
<th>Decision made by</th>
<th>Company 1</th>
<th>Company 4</th>
<th>Company 6</th>
<th>Company 10</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>President</td>
<td>3 members of management (CEO, CFO, Controller)</td>
<td>CEO (dominant decision-maker), CFO, and Controller</td>
<td>CFO</td>
</tr>
<tr>
<td></td>
<td>Board not involved</td>
<td>Board Chair</td>
<td>Justification memo for auditor switch provided to the Board, who in turn voted to accept the recommendation</td>
<td>No Board Involvement</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Information Sharing</th>
<th>Company 1</th>
<th>Company 4</th>
<th>Company 6</th>
<th>Company 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Idiosyncratic - the President liked the partners proposed by Big 4 Firms A and B so gave them extensive information and had candid and informal discussions with them.</td>
<td>Systematic though after bids were received, there was a preference for Big 4 Firm C who was asked to “sharpen their pencil” and generate a revised (lower) bid</td>
<td>Systematic – all bidders were given the same information</td>
<td>Systemic – all bidders were given the same information and told the fee was the main consideration</td>
<td></td>
</tr>
<tr>
<td>President didn’t like the partner proposed by Big 4 Firm C so didn’t meet with him – partner only had access to the Controller</td>
<td>Firm C made very little price revision but bundled in some free consulting hours in the audit fee</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Methodology</th>
<th>Company 1</th>
<th>Company 4</th>
<th>Company 6</th>
<th>Company 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Want comfort that the auditor understands the business (the same way as they do) so very interested in audit plan, hours and who does the work</td>
<td>Want someone thinking about our business</td>
<td>Very high emphasis on having auditor understand business as we understand it (=fit)</td>
<td>Don’t care what the auditor does – buying a certificate for the bank</td>
<td></td>
</tr>
<tr>
<td>Want high level review of disclosure</td>
<td>Want audit program to focus on the risks that management cares about</td>
<td>Liked the “free” consulting hours in the audit fee</td>
<td>Don’t believe the auditor has any great insight into the company’s operations based on the very limited time they spend on the audit</td>
<td></td>
</tr>
<tr>
<td>Big 4 Firm A tried to present its partner as having more autonomy (in contrast to the other firms) but the President thought this was cheap-talk and not credible</td>
<td></td>
<td>Really liked Firm A because they had courted the CEO, thought of the business (audit plan) the way management did, and proposed 4 meetings per year to avoid having any last minute surprises</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>What made winning auditors stand out?</th>
<th>Company 1</th>
<th>Company 4</th>
<th>Company 6</th>
<th>Company 10</th>
</tr>
</thead>
<tbody>
<tr>
<td>No expertise difference (audit is a commodity)</td>
<td>Low fee</td>
<td>Firm A solicited CEO prior to RFP. Had relationship with the dominant decision maker</td>
<td>Don’t believe what the auditor does – buying a certificate for the bank</td>
<td></td>
</tr>
<tr>
<td>Responsiveness – the incumbent reinstated a partner and manager liked by management</td>
<td>Audit is a commodity so even though CFO was Alumni of Big 4 Firm C (and really liked C), could not justify paying higher price</td>
<td>Auditor A brought National CEO to meet management – made them feel special</td>
<td>Don’t believe the auditor has any great insight into the company’s operations based on the very limited time they spend on the audit</td>
<td></td>
</tr>
<tr>
<td>Fee discount for 3 years – though not the lowest bidder</td>
<td></td>
<td>Think of the business the way management does, and series of scheduled meetings with management and the board</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Not fee – the highest bidder won (though not clear how to apportion fees between audit and consulting).</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
TABLE 3
What Users do with Private Company Audited Financial Statements

<table>
<thead>
<tr>
<th>Activity</th>
<th>Private Equity</th>
<th>Bankers</th>
<th>Bonding Agencies</th>
<th>Corporate Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Want projected cash flows</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Test operating assumption (e.g. order book of construction company)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Hire experts to do more detailed check on audited financial statement numbers (e.g. revenue recognition)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Hire experts to check contracts’ underlying cash flows and other important assets (e.g. check intellectual property ownership in employee contracts)</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Calculate cash flow measure(s)</td>
<td>• Sophisticated calculation of various versions of EBITDA, such as: EBITDA Forward EBITDA Maintainable EBITDA Normalized EBITDA Trailing Twelve Months EBITDA (TTM)</td>
<td>EBITDA</td>
<td>EBITDA</td>
<td>Operating Cash Flow</td>
</tr>
<tr>
<td>Assess management quality</td>
<td>• Very detailed assessment • Prefer to keep senior operating managers and have them retain a material shareholding in the company • Detailed assessment of education credentials and experience of managers • Depth of management • Succession plan • Detailed assessment • Has ongoing relationship with management • Very detailed assessment • Has personal knowledge of how management runs the company</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Governance and internal control</td>
<td>• Require company to have a Board • Control Board and appoint the Board Chair • Professionalize the Board and bring in new directors who have connections to important customers or suppliers • Have access to the auditor’s management letter on internal control • Look for presence of Board as it improves the firm’s governance rating • Perform public search on reputation of directors, especially those on audit committee • If the loan is very large, may request a meeting with auditor and/or copy of auditor’s management letter on internal control • No Assessment • Prefer a mix of insiders and outsiders on the Board • Have access to the auditor’s management letter on internal control</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Continued)
<table>
<thead>
<tr>
<th>Adjustments to Financial Statements</th>
<th>Private Equity</th>
<th>Bankers</th>
<th>Bonding Agencies</th>
<th>Corporate Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Partial write-off of audited values of current assets (A/R, Inventory)</td>
<td>Yes</td>
<td>Yes</td>
<td>Review</td>
<td>No</td>
</tr>
<tr>
<td>2. Adjust for tax shields</td>
<td>Yes</td>
<td>Review – not clear if they have expertise to make such adjustments</td>
<td>Review – not clear if they have expertise to make such adjustments</td>
<td>No</td>
</tr>
<tr>
<td>3. Related party transactions</td>
<td>Adjust to fair market value</td>
<td>Review</td>
<td>Review</td>
<td>Review</td>
</tr>
<tr>
<td>4. Adjust management’s compensation to fair market value</td>
<td>Yes</td>
<td>No adjustment made, but a limit on compensation is stipulated in a covenant</td>
<td>No, but managerial pay is deducted in financial calculations</td>
<td>No</td>
</tr>
<tr>
<td>5. Adjust capital structure</td>
<td>Yes, adjust to optimal level</td>
<td>Add unrecorded debt (e.g. Leases)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>6. R&amp;D</td>
<td>Appraise value</td>
<td>• Ignore – it is not liquid • Deduct from assets when inputting data into model</td>
<td>• Ignore – it is not liquid • Deduct from assets when inputting data into model</td>
<td>Approve/monitor investments</td>
</tr>
<tr>
<td>7. Proposed capital expenditures</td>
<td>Review and has to be approved by Board (which they control)</td>
<td>Review and want the Board’s strategy or operations committee to monitor and approve capital expenditures</td>
<td>Review</td>
<td>Conduct approval process on capital expenditures</td>
</tr>
</tbody>
</table>