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## Demand for and Assessment of Audit Quality in Private Companies

Financial statement audits are mandated in most countries, thus making it difficult to distinguish between auditing driven by private incentives versus that driven by regulation. Who would ask for an audit, and how would its quality be assessed in the absence of regulation? Many private companies in Canada get their financial statements audited even though the law does not require it. In this field study, we conduct interviews to discover reasons for demanding an audit, and criteria used to assess their quality. Our study reveals that both internal stakeholders (management, boards, and employees) as well as external stakeholders (customers, banks, and private equity firms) request audits. Users evaluate audit quality based on a variety of criteria such as the auditor's accounting expertise, the absence of errors, the fees involved, risk assessments offered, allocation of effort, internal control, and general business advice. Implications for audit regulations are discussed.

**Key words:** Audit quality; Regulation of audits; Sources of demand for audits of private firms; Field study.

One distinctive feature of private companies in Canada is that they are not required by law to make their financial statements public; nor are they required to have these statements audited. However, in many European countries (e.g., the UK) private companies are required to hire an auditor (Dedman *et al.*, 2014), as well as make their financial statements public. In this report, we investigate who demands the auditing of private companies, how agents who produce and/or use audited financial statements assess audit quality, and how the audited financial statements are used. We confine our study to private firms in order to isolate them from the consequences of regulatory requirements applicable to publicly traded companies.

This report is motivated by the debate surrounding the need for and consequences of auditing regulations. The regulatory mandate, combined with easier access to data, focuses most auditing studies on public companies, ignoring private incentives for audits (Jamal, 2008; Jamal *et al.*, 2003). The studies of public company audits reveal only the combined consequences of private incentives and regulation, although the outcomes are often attributed to regulation alone. Since archival

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evidence with large samples of private demands for audit from agents other than creditors has been more difficult to obtain despite early attempts by Chow (1982) and Abdel-Khalik (1993), economic analysis of private audit demands has remained largely focused on the market for debt (Allee and Yohn, 2009; Blackwell *et al.*, 1998; Leftwich, 1980; Lennox and Pittman, 2011; Minnis, 2011; Senkow *et al.*, 2001) with Dedman *et al.* (2014) being a notable exception. These studies generally find that the presence of an audit is correlated with better credit ratings and a lower cost of debt capital for private companies. Relatively little is known about the demand and use of audited financial statements by agents other than creditors.

This field study investigates who demands audits and how users assess audit quality through interviews with 27 principal participants in the field and by scrutinizing the relevant primary documents for specific company audits. We started by interviewing the CFOs of 11 private companies about how and why they hired an auditor (six had engaged Big 4 auditors and five had engaged others). We then interviewed five auditors (three Big 4 and two others) who serve private companies and various users of private companies' audited financial statements (four bankers, three board members, two bonding (surety) agencies, and two private equity firms). We asked each user to give us a detailed example of what information they use from financial statements and what other factors influence their analyses and decisions.

We find that a private company demand for an audit comes from a variety of agents including bankers, directors, bonding (surety) companies, customers, employees, lenders, other (non-securities-related) regulators, private equity firms, owners hoping to attract prospective buyers, and vendors. In addition, managers also use auditing data to help them with internal governance. We also find that these managers are especially responsive to requests from suppliers of equity capital by their tendency to hire a Big 4 auditor. When a demand for an audit comes from other sources, usually a bank, management is reluctant to provide audited financial statements and may hire a non-Big 4 firm at a lower cost.

In all 11 companies, the management—usually the President or the CEO—selected the auditor. Seven of the companies we interviewed had a board of directors in place, but the board members did not directly interview or choose the auditor. We observe that since there was little perceived audit (or accounting) expertise-based differentiation, the ability to deliver other services (like tax advice and consulting services) and relationship-based variables (like responsiveness, fit with client, e.g., 'makes me feel special') played 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 auditor selection.

For private companies, the auditor is an accounting expert and related business services provider (tax, internal control), rather than a fraud detector or monitor of management. The auditor's task is to professionalize the operation of the organization and to assist management in running the organization effectively and

efficiently. In certain ways, the external auditor is a part of the firm's control system that helps senior management to monitor other agents. This differs sharply from the rationale for mandated audits of public companies with their emphasis on protecting users of financial statements from managerial errors, malfeasance, or fraud.

## DEMAND FOR PRIVATE AUDITS AND REGULATION OF AUDIT SERVICES

Present laws in the US, Canada, and many other financially developed economies do not require private companies to hire an auditor. Why then do so many of them still do so? 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, 2016). 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; Lennox and Pittman, 2011). Our analysis shows that a much larger set of agents, especially the suppliers of equity capital, demand audited financial statements to support their contracts, decisions, and transactions with private companies. When they hire and pay for the cost of an audit in the absence of a regulatory mandate, it is reasonable to infer that they believe the benefit of the audit will outweigh its cost.

Agency theory provides a framework for thinking of a firm as a series of contracts among a set of agents. Agency theory posits a potential conflict of interest between a firm's shareholders and all other contracting agents (management, creditors, suppliers, customers, employees) who engage directly with the firm (Jensen and Meckling, 1976). Since shareholders are residual claimants, they have an interest in effective internal control to ensure that all other contracting agents provide the goods/services promised, and receive only the entitlements due to them that are commensurate with their contributions to the firm (Sunder, 1997). An auditor can help facilitate contracting by examining the existence of the organization's assets, the operation of internal control, and management's financial representations. A key requirement for an auditor to be useful in this setting is that the auditor should be able to monitor or improve internal control, and be willing to disclose when management is not truthful. Therefore, the auditor should be both an expert (in internal control and financial reporting) as well as independent of management (Watts and Zimmerman, 1983). Existing and prospective shareholders create a first-order private demand for financial reporting and auditing. Unless shareholders are a compact and stable group, it is quite likely that private companies will provide audited financial statements to their current and prospective shareholders voluntarily.

Other contracting agents such as bankers, board members, employees, suppliers, and customers have less pressing, second-order demands for routine audited financial reports since they are not residual claimants and can demand and/or obtain private information about the firm during the process of negotiating their

contracts. In theory, all contracting agents have a stake in the viability and continuity of an organization and could benefit from an audit (and good internal control) (Sunder, 1997). Without data from the field, it is unclear how likely a private company is to provide audited financial statements to these contracting agents; the literature suggests that bankers are more likely to be recipients than others.

All non-contracting agents (e.g., environmentalists) could be thought of as providing a third-order demand for financial reports and their audit. Agency theory suggests that it is unlikely that a private company will voluntarily make its financial statements (and incur the cost of an audit) available to such non-contracting agents. For these agents, public disclosure of audited financial statements would have to be mandated, and the mandate would have to be justified on the grounds of public interest (Dedman *et al.*, 2014).

In public markets, auditors help to contain the moral hazard of managers and protect external providers of capital, especially those who are remote from the company and do not have access to private information from the company. Shareholders and other users of financial statements do not observe the actions of auditors. Audit quality is thought to be inferred by shareholders and others from audit firm size (DeAngelo, 1981a, b), audit fees (Simunic, 1980), or other externally observable data such as issuance of modified audit opinions. These are essentially reputation-based arguments. Big audit firms having more to lose from an audit failure have an incentive to provide higher quality (effort, expertise, independence) in exchange for a fee premium relative to smaller audit firms (DeAngelo, 1981a, b). Audit may also be thought of as a credence good, with the users accepting it on the basis of some generalized trust in the auditor since they are unable to observe quality, even after the fact (Causholli and Knechel, 2012). Many of the mechanisms used by audit firms to price their services (standard hours of various grades of labour, standard hourly rates per grade of labour) are not observable to public shareholders and thus are not regarded as indicators of audit quality (Sunder, 1997).

For private companies, both accounting and auditing play a different role than they do for public companies. On the one hand, private companies have dominant shareholders who may abuse minority shareholders and consume perquisites from having corporate control (see Jensen and Ruback, 1983 for similar concerns in public companies as well). So instead of disciplining management to protect shareholders, auditors in private companies are helping to discipline dominant shareholders, who may also be managing the firm (top management). On the other hand, agents involved in private companies may have more direct access to internal information, direct access and ability to observe the auditor, and less reliance on published financial statements to understand the financial position of the company (Sunder, 1997). Users are not remote from the company. In private companies, there are more signals available to many stakeholders about the detailed conduct of the audit, though it is not clear whether these stakeholders are able to understand and use these signals.

Overall, agents involved in private companies should be less dependent on financial statements for gaining information about the company than public

company shareholders. However, given the potential for misconduct by the dominant shareholder, all stakeholders should desire auditor independence. For the auditor to create value, it is important that the auditor should be, and should be perceived to be, independent of the dominant shareholder (who is likely to be managing the private company). It is not clear if users of private company financial statements should devote extensive resources to monitor the auditor, even though they may be in a better position to directly observe and interact with the external auditor than public company shareholders.

## RESEARCH METHOD

Data were collected by interviewing participants and requesting primary documents pertinent to their decision-making process. A managing partner of a Big 4 accounting firm identified a set of private companies across Canada that had recently hired an auditor. Through the authors' personal contacts, and introductions made by the managing partner, we recruited 11 CFOs of private companies who were audited to take part in the study. These CFOs in turn identified other users (banks, private equity firms, bonding agencies, and directors) and we recruited 16 members of these user groups to participate in the study. While the sample is not randomly chosen, our participants are experts. In addition, our participants provided written supplementary documents that extend the information set significantly beyond what we learned in the interviews.

The interviews with CFOs and auditors about how auditors are chosen by private companies and the request for proposal (RFP) process generated insights beyond those documented in prior studies of how public companies appoint auditors (Cohen *et al.*, 2008; Fiolleau *et al.*, 2013). We were also able to triangulate comments provided by CFOs and audit partners by having them respond to a common RFP case study. Relative to the US, the Canadian banking industry is extremely concentrated with five big banks having about 90% of the market and the remaining market share spread among six regionally focused banks.<sup>1</sup> It is therefore unlikely that expanding beyond the four banks we interviewed will yield additional qualitative insights. While our sample of bonding agencies, private equity firms, and directors of private companies is small, these participants are very hard to access, and it is difficult to triangulate their responses given privacy and anonymity constraints. Field studies usually sample 12 or more participants of each type until saturation is reached (meaning no new insights are found). We achieve saturation in our CFO sample as our final interviews do not provide new insights into our research questions (Malsch and Salterio, 2016). Owing to difficulties in getting access to participants, and the concentrated nature of the

<sup>1</sup> Legally there are 28 Schedule I banks under the Canada Bank Act though most of these banks are owned by retailers and/or mobile phone companies. In addition, there are 24 Schedule II banks in Canada which are branches of foreign banks.

Canadian market (especially for banking) from which we draw participants, we have a smaller sample size and thus more preliminary findings. We do not claim to have reached saturation, except in the case of CFOs.

Twenty interviews took place over the phone with two members of the research team present; both took extensive notes during the interviews. Four face-to-face interviews also had two team members present, and three face-to-face interviews were conducted by one team member only. Our participants came from a range of professions and historically auditors have agreed to have their interviews recorded, whereas corporate directors are often resistant to being recorded due to reputation and litigation concerns (Clune *et al.*, 2014). We thus faced the prospect of having some participants willing, and some unwilling, to be recorded. Our consent form allowed us to record the interview, but our first participant (a CFO) refused to take part if the interview was recorded despite all the confidentiality and anonymity safeguards in our consent form. We then decided not to ask the subsequent participants for permission to record interviews since we did not want the recording of the interview or lack thereof, to become an uncontrolled variable in the study.<sup>2</sup> Our real-time field notes are the primary source of data in this research. After each interview, one researcher summarized the interview, while the other edited and reviewed the summary. Any discrepancies were resolved by discussion between the two researchers. 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 summaries were completed from September 2013 to June 2014.

One of the authors developed a template with the headings that are used in the tables presented in the paper. Appendix 1 describes the participants and what documents they provided. Appendix 2 describes the questions asked of the CFOs, which focus on size, who/how the auditor was selected (independence), what services the company purchased from the auditor (independence), and more open-ended questions such as what they wanted from the auditor and how they defined audit quality. Table 1 focuses on identifying agency theory-relevant variables such as the primary user, the existence of a board of directors, who hired the auditor, the size of the company, and the main decision maker. Table 2 reports the RFP data, and topic headings are based on categories used by Fiolleau *et al.* (2013) in their study of RFPs, including who made the auditor appointment decision, the role of fees, and other considerations (tax, services, independence) that influenced auditor choice in publicly held companies. Topic headings for Table 3 are based on user comments about their reliance on cash flow, and agency theory-related

<sup>2</sup> Tape recording of interviews is considered to be best practice in the field study literature and is considered to provide the highest quality of data (e.g., Malsch and Salterio, 2016). Our method of relying on field notes only provides a lower quality of data. We departed from the best practice because we sought to impose uniformity on the mode in which participation occurred. This imposition of uniformity (control) is generally thought to be unnecessary in the conduct of a field study where many variables are present but uncontrolled by the very nature of the setting. We did not provide a copy of our field notes to the interviewees for checking the accuracy of our notes as best practices would dictate. We did, however, provide a copy of the paper to each participant for review and comment. No participant raised any questions or objections to what is reported in the paper.

*AUDITING OF PRIVATE COMPANIES: A FIELD STUDY*

TABLE 1

BACKGROUND OF COMPANIES IN PRIVATE AUDIT STUDY

**Panel A: Companies audited by Big 4 audit firm**

Company	Primary user of audit	Has board of directors	Chose auditor using RFP	Sales (\$)	Primary decision maker
1	Other regulator	Yes	Yes	Part of \$2 billion company	President
2	Equity	Yes	No	400 million	CEO
3	Bank	Yes	No	50 million	CEO
4	Equity	Yes	Yes	200 million	CEO
5	Equity	Yes	No	60 million	CFO
6	Equity	Yes	Yes	590 million	CEO

**Panel B: Companies audited by non-Big 4 audit firm**

Company	Primary user of audit	Has board of directors	Chose auditor using RFP	Sales (\$)	Primary decision maker
7	Customer	No	No	11 million	CEO
8	Bank	Yes	No	220 million	CEO
9	Bank	No	No	15 million	CEO
10	Bank	Yes	Yes	300 million	CFO
11	Bank	No	No	11 million	CEO

variables such as the quality of management, governance, and internal control, and adjustments made to the audited financial statements. Data reported in the tables were first input by one of the authors from the interview summaries. A student research assistant who was not familiar with the investigation in the study independently filled out the tables. Then the author and the research assistant discussed their coding to reach a consensus. The coding results were then provided to the other co-authors who also had copies of the interview summaries to review propriety of the coding.

We prepared for interviews by developing a template questionnaire for the CFO of each company (see Appendix 2). The questions were developed based on the four research areas that are the focus of this study: 1) Obtaining background information on each company. This consisted of four questions (Q1–Q4) asking about industry, ownership, corporate structure, and size (in assets), sales, and number of employees, because these variables are generally used as proxies for magnitude of agency costs in the private company audit literature. 2) Probing auditor selection aspects. The next four questions (Q5–Q8) explored who chose the auditor and auditor selection criteria. These questions focus on independence and in particular the suggestion that the auditor appointment process has a major impact on auditor independence, which is of substantive interest in this study. 3) The demand for and perceived uses of audit. The next two questions (Q9–Q10) probed the demand for auditing services and what the participants thought the users did with audited financial statements (which is important for understanding demand). 4) The audit assessment and ancillary uses. The next nine questions (Q11–Q19) were more open-ended and probed how the participants assessed audit

quality and included the demand for other services—a proxy for agency costs—such as service quality dimensions like responsiveness of the audit partner, auditor risk assessment and time budget, and what attributes they would seek in a new audit partner.

The interviewees received the script in advance.<sup>3</sup> 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 the RFP process so we asked these companies for a copy of their RFPs. Only one company provided a copy. 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 in competing for the work. 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 with which they are involved. 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. We provide summary statistics, interview quotes, and some tentative generalizations to communicate the rich and diverse data we collected.

<sup>3</sup> Field studies usually start with a more open-ended discussion in which the subject speaks first before the interviewer asks a more directive and formal written set of questions. This is thought to generate the highest quality of field data, the best recall, and response informativeness (see Malsch and Salterio, 2016). We departed from this best practice and provided a written script in advance of the interview because we felt that providing interview questions in advance would make it more likely that potential participants would agree to participate in the study. We also felt that providing a written script would make it easier to obtain ethics approval for the study.



## FINDINGS

### *Who Demands an Audit?*

Our respondents identified a primary user who motivated them to hire an auditor (see Table 1). Five companies identified the bank as the primary user who demanded audited financial statements in addition to other monthly and quarterly reports. One CFO said:

The bank requires annual financial statements, a monthly schedule of work in process, quarterly (interim) financial statements, and a quarterly ratio analysis for compliance with covenants. (CFO 3)

Table 1 shows that four of these companies chose non-Big 4 auditors and only 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 their auditor. One company identified a customer as the dominant reason for hiring an auditor and hired a non-Big 4 firm as their auditor. One company identified another regulator as the dominant reason for hiring an auditor and hired a Big 4 firm as the auditor.

Ten of our 11 CFO participants mentioned their bank as a user, nine mentioned themselves as users, seven mentioned governance, five mentioned customers, five mentioned other users (bonding, other regulators), and five mentioned shareholders. Only one mentioned employees (who were also shareholders, though in this case the audited numbers had a significant effect on their wealth), and two explicitly mentioned that they resist giving audited financial statements to customers and vendors who ask for them. All CFO participants stated that they did not make their financial statements available to the general public.

The identification of users has a strong agency theory orientation. There was frequent mention of the independence and expertise of the external auditor, and how management itself, as well as others, gain a sense of security from an external audit. Management also made statements about how the auditor is an important part of their own internal control system, and how auditor recommendations for control improvements help them to promote better business processes inside the organization. For example, a CFO said:

We [management] feel more confident in reporting to the Board and internally as we have had an expert and independent review of our work. (CFO 4)

Another CFO said:

All employee shareholders get an audited financial statement annually. They feel comfort knowing the financial statements have been independently audited. Audited numbers set the book value and earnings numbers which value their shares both for buying new shares and selling existing holdings. (CFO 3)

These patterns of engaging auditors are consistent with user preferences. We asked four bankers about their preference for an auditor, but they all claimed not to have any. Likewise, the two bonding (surety) companies claimed to have no preferred auditor. Bankers had lists of their preferred (or recommended) lawyers and valuers, but not auditors. CFOs also did not think that bankers had any preferred auditor. For example, a CFO said:

It doesn't matter who the auditor is. The banks don't care who the auditor is. They just want to know the financial information is accurate. (CFO 6)

Bankers and bonding agencies reported being lobbied by some 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. They stated that 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) and stated that competitive pressures often led them to relax their demand for an audit. Lisowsky *et al.* (2017) also document how demand for audit gets relaxed/tightened based on the credit cycle.) One of the bankers said:

The markets are awash in capital for the last 15 years so borrowers have a lot of power. While we always like higher levels of information quality, we are often not in a position to demand this. Private companies don't see much value in an audit, so resistance is high. (Banker 4)

We observe that bankers considered 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 immediately reduce interest rates for getting an audit. A banker said:

No special inducement [lower interest rate] is provided to borrowers who get audited. Getting an audit is just a requirement for the normal risk management process of the bank. (Banker 3)

Likewise, a CFO confirmed that when he asked for a direct inducement for getting audited, he received 'no better borrowing rate and no better terms' (CFO 5).

We find that bankers generally required an audit from companies that 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 a lower cost of debt. We also observe that bankers did not perceive a causal relationship between being audited and cost of debt; this relationship was seen as being driven by an omitted variable (profitability and growth of loan). Bonding agencies also claimed to offer pricing discounts based on volume of business, and not explicitly for audited financial statements.

We note that private equity firms and corporate directors responded quite differently to questions about their preferences for auditing services. All five respondents (two private equity, three directors) started by saying they had a strong preference for a Big 4 audit firm but might accept a national firm if it had the requisite industry experience. 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. All respondents stated that there was a lot of variance within audit firms and that specific partners often determined the quality of service received. Loyalty was often to the partner and one CFO said so explicitly: 'If Partner A left, we might follow him. That's where the relationship is. Not with the firm' (CFO 3). This pattern of responses is consistent with previous findings: companies that access equity markets tend to retain Big 4 auditors, whereas clients of non-Big 4 auditors mainly rely on debt financing (Chang *et al.*, 2009).

#### *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. Auditor independence has generally been considered to be the most important attribute underlying audit quality (Mautz and Sharaf, 1961). 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. The literature's recent focus has been on whether audit committees actually carry out their legislated mandate effectively (Folletau *et al.*, 2013), and whether or not management continues to have significant influence over the auditor appointment decision despite attempts made in the SOX to minimize such influence (Dhaliwal *et al.*, 2014). We observe that in our setting, private equity firms and banks could easily play a decisive role in auditor selection if they choose to.

In our study of private markets, we find that top management selects the auditor. Our findings in Table 1 show that in all 11 cases we examined, top management (usually the CEO, but not the CFO) had the dominant say in choosing the auditor. In private companies, the CEO is often a major shareholder of the company but there may be a conflict between the CEO and minority (or prospective) shareholders. CFOs and board members also explicitly acknowledged that personal relationships were important in auditor choice. We observe that for the most part, the choice of an 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, we find that top management had the final say in auditor choice.

Participants in private markets made no mention about independence in this part of the discussion, which was a bit of a concern to us given the possibility of a

dominant shareholder taking advantage of minority shareholders. This is possibly because various agents (private equity firms, bankers) can monitor the auditor directly by taking a seat on the board. As board members, 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 the accounting estimates.

Private equity firms could influence an auditor choice<sup>4</sup> (as could bankers) but we find that they do not. They were quite emphatic in claiming that they did not play any role in determining which auditor was chosen. We observe that these agents took the auditor's independence for granted and wanted management to choose an auditor who they (management) would respect and listen to. Audit partners invest much time and effort developing business networks and told us that they prefer to obtain business through 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 (two of them served on companies in our sample) had actually been actively involved in selecting the auditor. In seven of our companies there was a board, but we find no case where the board had taken the lead in selecting the auditor.

We find that 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 internal controls. A perception that the auditor is less than forthcoming severely undermines the trust and relationship with the auditor. This is the only place where participants indirectly discussed an aspect of what could be considered to be auditor independence. We find that auditor independence (and competence) were assessed through direct discussion with the audit partner. 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 clear preferences for some partner(s) over others in each audit firm.<sup>5</sup>

We find that all users wanted an auditor to be an accounting expert and to understand the industry. CFOs, directors, private equity firms, bankers, and

<sup>4</sup> 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 (e.g., 30%), which gives them one or more seats on the board and significant influence on corporate decisions.

<sup>5</sup> The audit research literature has identified audit firm office size, and dominance in a local market, as important determinants of audit quality (Francis *et al.*, 2005). However, none of our participants mentioned the office; only the firm name and individual partners.

bonding agencies cared about the reliability of accounting data, wanted an expert to proofread all disclosures, and the existence of an independent audit added to their confidence in the financial statements. All CFOs wanted accounting advice, and sometimes wanted the auditor to do some accounting work for them. We observe that 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. CFOs 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 incompetent and risked getting fired by the company. We find that all users were receptive to auditors' business advice. 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. The ability to provide tax and various types of business advice was clearly a positive factor that would favour 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. In many cases management (and other employees) desired personal tax planning advice as well. For example, a director said:

In addition to an audit, the board members want tax advice for the company as well as systems advice. Any advice on how to make the company more profitable or more efficient is desired. How can the audit firm help us earn more money? (Director 1)

We find that users were receptive to auditors' help in connecting them to business networks (including lenders as acknowledged by CFO 8). Expectations of such assistance were not high. We saw little anxiety about conflict of interest or concerns about knowledge spillovers to competitors. There was also no explicit discussion of independence or any public interest issues. The entire discussion on auditor selection focused on accounting expertise, improvement of business processes, and improving the efficiency and profitability of the business. The lack of discussion or concern about independence was surprising to us, since private companies do face moral hazard issues relating to dominant shareholders abusing their power and obtaining benefit at the expense of minority shareholders.

Eight companies (out of 11) 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. We observe that 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. Clients of non-Big 4 firms tended to

purchase tax expertise from lawyers, possibly suggesting reluctance on the part of non- Big 4 firms in having their clients involved with competing Big 4 audit firms.

### *The Request for Proposal Process in Private Companies*

Cost is the final consideration in hiring an auditor. We observe a widespread feeling that there is little or no difference in the quality of service across all audit firms. Commoditization of auditing combined with a recession created pressure on audit pricing.<sup>6</sup> The general view across all CFO respondents was that an RFP was an effective device for lowering the audit fee (and CFO 7 claimed they lowered their audit fee by 50% by putting it up for bid), 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 develop personal relationships with senior managers and/or corporate directors. All three directors in our sample expressed a preference for periodic audit tendering as a good governance practice. 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 used 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 was 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.

Table 2 shows that Company 1 had a large subsidiary that was poorly run and was performing poorly. A decision was made to invest significant amounts of additional capital, improve internal controls, and improve the 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, brought in a younger partner, and had poor staff continuity. The President decided to send out an RFP for bids to significantly reduce the audit fee, and to send a signal to the auditor that it was not being responsive to its business and its changing environment.

Three Big 4 firms (A, B, and C) bid on this audit, offering prices ranging from 40–76% of the preceding year's fee. We observe that the information acquisition process was quite idiosyncratic. The President was a one-person committee who chose 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

<sup>6</sup> 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.

TABLE 2

SUMMARY OF REQUEST FOR PROPOSAL PROCESSES FOR SELECTING A PRIVATE COMPANY AUDITOR

	Company 1	Company 4	Company 6	Company 10
<b>Incumbent auditor</b>	Big 4 Firm A	Non-Big 4 firm	Big 4 Firm D	Big 4 Firm D
<b>New auditor</b>	Big 4 Firm A – No auditor change	Big 4 Firm D – Auditor change	Big 4 Firm A – Auditor change	Non-Big 4 (national) firm – Auditor change
<b>Why do an RFP?</b>	<ul style="list-style-type: none"> <li>Want a substantially lower fee (had made major injection of capital, improved internal control, and hired a more capable Controller)</li> <li>Want a partner with more stature</li> </ul>	<ul style="list-style-type: none"> <li>Want Big 4 auditor to prepare company for sale to private equity firm</li> <li>Get best auditor</li> </ul>	<ul style="list-style-type: none"> <li>Lack of fit with current auditor (Firm D)</li> <li>They don't think about the business the way management does</li> <li>Had last minute adjustment to financial statements (surprise)</li> <li>Management was being solicited by Big 4 Firm A's office managing partner</li> <li>Get best auditor</li> <li>All Big 4 firms (A, B, C, D)</li> </ul>	<ul style="list-style-type: none"> <li>Want low fee (concluded that audit doesn't provide much value)</li> </ul>
<b>Who is invited to bid on RFP?</b>	<ul style="list-style-type: none"> <li>All Big 4 firms (A, B, C, D)</li> <li>One non-Big 4 (local firm)</li> </ul>	<ul style="list-style-type: none"> <li>Three Big 4 firms (A, C, D)</li> <li>Didn't like Big 4 Firm B – thought they would bid low and then extra-bill</li> </ul>	<ul style="list-style-type: none"> <li>All Big 4 firms (A, B, C, D)</li> <li>Firm A courted the CEO</li> <li>Firms B, C, and D courted directors</li> </ul>	<ul style="list-style-type: none"> <li>Two Big 4 firms (C, D)</li> <li>Three national firms</li> </ul>
<b>Firms that bid</b>	<ul style="list-style-type: none"> <li>Three Big 4 firms (A, B, C) bid – all had ties with the President</li> <li>Big 4 Firm D did not bid because it thought this RFP was just to reduce the fee and would go to the incumbent</li> </ul>	<ul style="list-style-type: none"> <li>Three Big 4 firms (A, C, D)</li> <li>Firm A had no ties to management or the board</li> <li>Firm C had ties to a director and the CFO was an alumni of Big 4 Firm C</li> <li>Firm D had ties with a director</li> </ul>	<ul style="list-style-type: none"> <li>All Big 4 firms (A, B, C, D)</li> <li>Firm A courted the CEO</li> <li>Firms B, C, and D courted directors</li> </ul>	<ul style="list-style-type: none"> <li>Two Big 4 firms (C, D)</li> <li>Three national firms</li> <li>One national firm did a lot of consulting work for the company but did not get chosen to be auditor</li> </ul>

TABLE 2  
CONTINUED

	Company 1	Company 4	Company 6	Company 10
<b>Fees</b>	<ul style="list-style-type: none"> <li>Local firm did not bid because it thought it lacked the industry expertise needed to audit this client</li> <li>Incumbent Big 4 Firm A bid 57% of last year's audit fee in a two-step process where they first bid 75% of last year, and then gave a special discount bringing the fee down to 57%</li> <li>Big 4 Firm B bid 76% of last year's fee</li> <li>Big 4 Firm C bid 40% of last year's fee</li> <li>President</li> <li>Board not involved</li> </ul>	<ul style="list-style-type: none"> <li>Big 4 Firm A was the highest bidder and deemed not to be too enthusiastic</li> <li>Narrowed down choice to Firms C and D</li> <li>Firm C's bid was 62.5% higher than Firm D's bid</li> </ul>	<ul style="list-style-type: none"> <li>Big 4 Firm A was the highest bidder but had bundled 'free consulting' hours into the audit fee (no other firm had bundled consulting with audit)</li> </ul>	<ul style="list-style-type: none"> <li>One national firm bid 50% of last year's audit fee so they were the lowest bidder</li> </ul>
<b>Decision made by</b>	<ul style="list-style-type: none"> <li>Three members of management (CEO, CFO, Controller)</li> <li>Board chair</li> <li>CEO is the dominant decision maker</li> </ul>	<ul style="list-style-type: none"> <li>CEO (dominant decision maker), CFO, and Controller</li> <li>Justification memo for auditor switch provided to the board, which in turn voted to accept the recommendation</li> </ul>	<ul style="list-style-type: none"> <li>CFO</li> <li>No board involvement</li> </ul>	
<b>Information sharing</b>	<ul style="list-style-type: none"> <li>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</li> </ul>	<ul style="list-style-type: none"> <li>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</li> </ul>	<ul style="list-style-type: none"> <li>Systematic—all bidders were given the same information</li> </ul>	<ul style="list-style-type: none"> <li>Systemic—all bidders were given the same information and told the fee was the main consideration</li> </ul>



TABLE 2  
CONTINUED

	Company 1	Company 4	Company 6	Company 10
	<ul style="list-style-type: none"> <li>• President did not like the partner proposed by Big 4 Firm C so did not meet with him — partner only had access to the Controller</li> </ul>	<ul style="list-style-type: none"> <li>• Firm C made very little price revision but bundled in some free consulting hours in the audit fee</li> </ul>		
<b>Methodology</b>	<ul style="list-style-type: none"> <li>• Want comfort that the auditor understands the business (the same way they do) so very interested in audit plan, hours, and who does the work</li> <li>• Want high-level review of disclosure</li> <li>• 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</li> </ul>	<ul style="list-style-type: none"> <li>• Want someone thinking about our business</li> <li>• Want audit program to focus on the risks that management cares about</li> </ul>	<ul style="list-style-type: none"> <li>• Very high emphasis on having auditor understand business as we understand it (“fit”)</li> <li>• Liked the ‘free’ consulting hours in the audit fee</li> <li>• Really liked Firm A because it had courted the CEO, thought of the business (audit plan) the way management did, and proposed four meetings per year to avoid any last minute surprises</li> </ul>	<ul style="list-style-type: none"> <li>• Do not care what the auditor does—buying a certificate for the bank</li> <li>• Do not believe the auditor has any great insight into the company’s operations based on the very limited time they spent on the audit</li> </ul>
<b>What made winning auditors stand out?</b>	<ul style="list-style-type: none"> <li>• No expertise difference (audit is a commodity)</li> <li>• Responsiveness—the incumbent reinstated a partner and manager liked by management</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Low fee</b></li> <li>• Audit is a commodity so even though CFO was alumni of Big 4 Firm C (and really liked Firm C), could not justify paying a higher price</li> </ul>	<ul style="list-style-type: none"> <li>• Firm A solicited CEO prior to RFP. Had relationship with the dominant decision maker</li> <li>• Auditor A brought in national CEO to meet management—made them feel special</li> </ul>	<ul style="list-style-type: none"> <li>• <b>Lowest fee</b></li> </ul>

TABLE 2  
CONTINUED

Company 1	Company 4	Company 6	Company 10
<ul style="list-style-type: none"> <li>• <b>Fee discount</b> for three years—though not the lowest bidder</li> </ul>		<ul style="list-style-type: none"> <li>• Think of the business the way management does, and series of scheduled meetings with management and the board</li> <li>• Not fee—the highest bidder won (though not clear how to apportion fees between audit and consulting)</li> </ul>	

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.<sup>7</sup>

In a field study of public company RFPs, Fiolleau *et al.* (2013) report that auditors in an RFP usually expect the incumbent to bid the same fee as the preceding year. However, the incumbent (Big 4 Firm A) 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. As shown in Table 2, the incumbent assessed 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 the prior year's fee. A previous partner and manager who were liked by management were re-assigned to this engagement, and assurances were provided regarding staff continuity. One Big 4 competitor (Firm C, which 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 be accepted.

In Company 4, we note that management wanted a Big 4 firm because they planned 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 favoured Firm C, the lowest bid came from Firm D. Firm C was given a second chance to revise their bid and 'sharpen their pencil' and come up with a lower bid. Firm C did not lower their bid much but included 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 of the audit as a commodity and despite his personal preference for Firm C, he could not justify advising the CEO to pay more.

In Company 6, we find that 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 an RFP. We observe that 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.

<sup>7</sup> This type of idiosyncratic performance is unlikely to occur in public companies where a formal process would be set up to be equitable to all auditors invited to bid in an RFP.

Management felt that audit 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. Firm A bundled in some ‘free’ consulting hours in their audit fee.<sup>8</sup> 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 committee and no disclosure requirement, bundled the fees for audit and consulting services into a single line item labelled ‘audit fee’. Officially, the client paid no consulting fee. Management claimed to be extremely pleased with their new auditor (Firm A) and has subsequently sought advice on several major finance-related issues from the auditor.

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

Table 2 shows that on three out of the four RFPs, there was a substantial reduction in audit fees and most CFOs asked for a three-year quote to keep them from raising the audit fee after the initial engagement. CFOs believed that the result of putting the audit out for tender is a significantly reduced audit fee. This turned out to be true. Likewise, auditors were quite aware of how they and their competitors would present themselves to the company.<sup>9</sup> 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. We find that the RFP process had one clearly dominant decision maker in all cases. That individual could concentrate on understanding the risks, controls, and the need for business services. We observe that the lack of differentiation in accounting or audit-related expertise meant that a lower fee, pre-existing client relationship, or provision of non-audit services were major determinants of which auditor was hired.

### *Summary of the Request for Proposal Process*

As agency theory suggests, private companies were quite keen to hire a Big 4 auditor to meet the demands of current or prospective shareholders—the first-order users of an audit. While bankers were also a key source of demand for an

<sup>8</sup> The hours could be used for seeking accounting and audit assistance, tax advice, or more general consulting services.

<sup>9</sup> Previous experimental research suggests that auditors have weak interpersonal expertise in understanding other auditors (Tan and Jamal, 2001), and how others view them (Jamal and Tan, 2001; Tan and Jamal, 2006), though in a field setting auditors seem to have very good interpersonal expertise, and they have an accurate understanding of what management wants, and how their competitors will respond in that setting. It is possible that management leaks information about bids received to their preferred audit firm thus making the winning bidder appear to be prescient. No manager or auditor mentioned this, although there is extensive (and uneven) private communication between the auditor and management.

audit (as reported ubiquitously in the literature), there was surprisingly high resistance from private companies to hire an auditor in response to a bank's demand. We observe that private companies sought to obtain a direct inducement such as a lower cost of debt (which was not immediately forthcoming), hired a non-Big 4 auditor, or sought to water down the audit requirement by providing a Review Report or a Notice to Reader Report. We observe major internal demand for audit reports in addition to external demand. Management and the board of directors considered themselves to be major users and beneficiaries of audits. Studies of customer satisfaction show that companies pay substantially more for audits where the satisfaction is obtained by internal agents (management and board members), and not just for attributes observed by external agents (Behn *et al.*, 1999; Hoang *et al.*, 2017). Providing audited financial statements to contracting agents other than shareholders (second-order demand) was uneven, and management was quite unwilling to provide audited financial statements to vendors and customers. As expected, no companies were willing to provide audited financial statements to the general public (third-order demand) without a government mandate.

We observe that in private companies, top management (usually the CEO) selects the auditor, and we find that companies seeking access to 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 value auditor expertise, that is, they want the auditor to be a business advisor and to provide tax, internal control, and business services that help the company operate more efficiently and become more profitable. The extent of the demand for auditor expertise has been under-appreciated in the research literature due to the overwhelming focus on public company audits. Our participants made no explicit mention of independence concerns or leakage concerns about auditors sharing their private information with competitors. This high focus on expertise, and lesser focus on independence, is the opposite of what we observe in discussions of auditing in public markets. Regulators have sought to minimize any conflicts of interests when auditors also provide business services to their audit clients by demanding that audit committees hire the auditors for public companies, and restricting purchase of business services from their own auditors. The success of regulators in counteracting these underlying strong private incentives remains unclear (see Dhaliwal *et al.*, 2014; Fiolleau *et al.*, 2013 on continuing management influence in selecting public company auditors), and there is reason to doubt whether restricting consulting services serves shareholder interests (Kinney *et al.*, 2004).

More recently, regulators have sought to require audit firm rotation and/or require audit committees to put audits out for tender (i.e., RFP) with the claim that it will promote auditor independence. Field observations suggest that, on the contrary, audit firm rotation may only serve to drive down the audit fees as undifferentiated audit firms vie for customers by discounting their audit fees in the hope of building client relationships and recovering losses from the sale of business services. Our observations suggest that regulated periodicity of tendering the audit is likely to diminish, not enhance, audit independence and quality.

Regulators have succeeded in making audited financial statements available to the public, but have failed in influencing how public companies select an auditor, and what non-audit services they purchase from their auditors. The auditing research literature has under-appreciated how the process of appointing the external auditor undermines the attainment of auditor independence (Mayhew and Pike, 2004 is a notable exception). In most respects, the RFP process in private firms is similar to the RFP process in public companies (Fiolleau *et al.*, 2013).

### *How Is Audit Quality Assessed?*

We find that the overwhelming criterion for assessing audit quality is the quality of the output of the accounting system; namely, the quality and reliability of the financial statements. Except for three CFOs who were interested only in the cost of buying an audit certificate, the other CFOs and users of financial statements cared that an effective audit was 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 position's responsibilities.

The first opportunity to assess audit quality is in the review of the audit plan. According to audit standards, audit planning judgements (audit hours, risk assessments, staffing, and timing) are made by the auditor to bring the risk of audit failure down to an acceptable level. Auditing standards imply that such audit planning judgements are made privately by the auditor, though in public companies, and especially in the audit of private companies, these judgements are not made by the auditor alone, but are made in consultation with the CFO and reviewed/approved by the board. CFOs treated the external auditor as if (s)he were a part of the company's internal (or their personal) control system, and it was normal 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 the absence of a 'fit' with the CFO. For example, one CFO said:

I want the auditor to focus on key risk areas [inventory] and not waste time on 'useless procedures' auditing fixed assets and leases like the previous auditor. I want the auditor to be part of management's internal control. They are being paid by the hour, and I want hours to be spent where management perceives a risk. I don't want the auditor to waste hours in useless activities. (CFO 6)

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. We find that 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 unacceptable. 'They have to be told where to do the testing' Director 1 said. An auditor whose risk assessment did not conform to the CFO's and board members' views of where the key risks

were, and where the major audit effort should be allocated, was deemed to be incompetent.<sup>10</sup> For example, a director said:

Board members care about the total audit fee as well as the audit firm's work plan and breakdown of hours. We want to see that the "right" people are doing the work and are spending time on the areas with the most risk. Board members will interview the audit team. The Board wants the audit firm to be in synch with how the Board views the business. The Audit firm "needs direction". The audit firm can't just do its own audit as it sees fit. If the audit firm's view of the business is not in synch, the auditor would be unsuccessful. (Director 1)

There was no mention of fraud detection, and it is difficult to see how the auditor can be strategic (Johnson *et al.*, 1993, 2001) and an effective fraud detector when all audit planning is done in consultation with management and the board. One difference between a private company audit and its public counterpart is this personalization of audit monitoring. Public company shareholders do not communicate directly with the auditor. CFOs and directors are also thought to be acting on behalf of public shareholders. We find that in private companies, risk is perceived in a more personal manner. The CEO and board members want the auditor to focus activity on areas where they personally perceive risk, not where the auditor perceives risk. This need for the auditor to be responsive (and 'fit') to what some specific agent wants makes it difficult to think of the auditor as an independent agent working for the public good.

We observe that a second facet of assessing audit quality came from accounting policies, disclosures, and adjusting journal entries made at year-end. All CFOs and directors wanted the auditor to be an accounting expert, to be responsive, the numbers and disclosures to be accurate, and presentation to be at the level of 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, we find that CFOs and directors monitored the number of adjusting journal entries at 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 year-end. To them, the audit was supposed to confirm the accuracy of previous reports produced by the company (Demski and Feltham, 1994).

A third facet of audit quality we observe is the advice provided on improving internal controls, tax, and other business processes. The CFO, directors, private equity firms, and sometimes even bankers claimed that they read the auditor's

<sup>10</sup> The managing partner of a Big 4 firm said that their audit methodology requires the engagement partner to consult with key management personnel and board members about where the client perceives risk and then incorporate that into the audit plan. While the audit partner has the right to do procedures even if the client disagrees, he thought the quote from CFO 6 above showed a failure of communication between the auditor and the CFO. He could not imagine doing an audit without client input at the audit planning stage.

management report and were keen to know the auditor's 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. We find that 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 boilerplate content. They also want their generally accepted accounting principles (GAAP) preferences to be consistent with those of their auditor (another aspect of 'fit' between the auditor and some internal agent; see also Jamal and Tan, 2010).

In addition, we find that the auditor is expected to provide business process advice. It is not sufficient to limit recommendations only to accounting and control issues. The auditor has 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 conservative and not pitch very aggressive tax schemes.

In our sample, there were three CFOs who were merely buying an audit certificate because someone else wanted it. This is consistent with one view of the audit (see also Sunder, 1997 who models such an approach). The remaining interviewees were quite emphatic that they cared about what the auditor did. The level of detailed scrutiny of risk assessments, audit hours, hourly rates, staff continuity, accounting expertise, internal control, and business process recommendations was surprising. The emotional vehemence with which participants expressed their concern about where the auditor spent their time and the view that an auditor whose risk assessments/time allocation did not match their own was incompetent, was also surprising. This focus on 'fit', that is, does the auditor see things just the way the managers do, is usually seen as undermining the independence of the external auditor in public audit markets (Fiolleau *et al.*, 2013). Public company shareholders may know little about what an auditor does or finds during an audit, but in private companies we observe that the auditor is monitored intensively by a variety of agents; it is not a credence good (Causholli and Knechel, 2012).

We find no overt concern about independence. To management and users (directors, private equity) the auditor is a team member helping to make the company more profitable, and possibly protecting themselves personally. We observe no interest in general independence. The auditor had to 'fit' the preferences and approach of each agent individually. That is also how audit firms marketed themselves. For example, in response to the RFP from Company 1, one Big 4 audit firm said (in writing):

Partner X will bring extensive knowledge to the management team and oversee the quality of the audit. Partner X's passion for client service will ensure he sees things from your point of view, is accessible and responsive. He will be your single point of accountability and the key decision maker on all important matters relating to the audit of your financial statements.



While the RFP did ask the audit firm to confirm its independence from the company, the prior response indicates that at least one Big 4 audit firm was not particularly careful to appear objective or independent from top management (the CEO). Since top management made the auditor appointment decision, we infer that the Big 4 firm wanted to be seen as being in synch with top management, and therefore made a written representation about seeing things ‘from your point of view’. While public company auditors are more careful in making written representations in their RFP (which can be seen by regulators), Fiolleau *et al.* (2013) document similar practices of the external auditor trying to emphasize their ‘fit’ with management of public companies as well. The auditing literature has generally not recognized the strong private incentives for auditor expertise, and the much weaker private demand or concern for auditor independence.

#### *Use of Accounting Numbers in Decision Models*

*Private Equity Firms* Based on two interviews and one detailed analysis of a quality of earnings record, we observe that both private equity firms described a five-part decision-making process (see column 1 in Table 3). The first step was to obtain and review audited financial statements as well as management’s projections of cash flow for the next five years. Second, the operating assumptions underlying the cash flow projections would be tested as part of the due diligence process. Third, a ‘Quality of Earnings Assessment’ would be performed. The focus of this analysis is to estimate the sustainable cash flow expected from this business available to pay off debt and taxes (i.e., earnings before interest, tax, depreciation, and amortization (EBITDA)). The sales growth estimates provided by management would be used to calculate estimated EBITDA for the next five years. Then a series of adjustments would be made to calculate normalized EBITDA. Fourth, management quality would be assessed. 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. A private equity participant said:

The audited financial statements would just be step one in a due diligence process. I would test the operating assumptions underlying cash flow assumptions [e.g., looking at the order book of a construction company] and may hire a specialist in construction revenue recognition to check the underlying construction contracts and propriety of their accounting. I would do a “stress test” on the balance sheet and even think through the purchase price allocation and how much would be assigned to goodwill versus various identifiable tangible and intangible assets. (Private Equity 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 interviewed four bankers and examined one lending contract as well as two detailed examples of risk-rating

TABLE 3  
WHAT USERS DO WITH PRIVATE COMPANY AUDITED FINANCIAL STATEMENTS

	Private equity	Bankers	Bonding agencies	Corporate directors
Want projected cash flows	Yes	Yes	Yes	Yes
Test operating assumption (e.g., order book of construction company)	Yes	Yes	Yes	Yes
Hire experts to do more detailed check on audited financial statement numbers (e.g., revenue recognition)	Yes	No	No	No
Hire experts to check contracts' underlying cash flows and other important assets (e.g., check intellectual property ownership in employee contracts)	Yes	No	No	No
Calculate cash flow measure(s)	<ul style="list-style-type: none"> <li>• Sophisticated calculation of various versions of EBITDA, such as:                             <ul style="list-style-type: none"> <li>◦ EBITDA</li> <li>◦ Forward EBITDA</li> <li>◦ Maintainable EBITDA</li> <li>◦ Normalized EBITDA</li> <li>◦ Trailing 12 months EBITDA (TTM)</li> </ul> </li> </ul>	EBITDA	EBITDA	Operating cash flow
Assess management quality	<ul style="list-style-type: none"> <li>• Very detailed assessment</li> <li>• Prefer to keep senior operating managers and have them retain a material shareholding in the company</li> <li>• Require company to have a board</li> </ul>	<ul style="list-style-type: none"> <li>• Detailed assessment of education credentials and experience of managers</li> <li>• Depth of management</li> <li>• Succession plan</li> </ul>	<ul style="list-style-type: none"> <li>• Detailed assessment</li> <li>• Has ongoing relationship with management</li> </ul>	<ul style="list-style-type: none"> <li>• Very detailed assessment</li> <li>• Has personal knowledge of how management runs the company</li> </ul>
Governance and internal control	<ul style="list-style-type: none"> <li>• Require company to have a board</li> </ul>		<ul style="list-style-type: none"> <li>• No assessment</li> </ul>	

TABLE 3

CONTINUED

	Private equity	Bankers	Bonding agencies	Corporate directors
	<ul style="list-style-type: none"> <li>Control board and appoint the board chair</li> <li>Professionalize the board and bring in new directors who have connections to important customers or suppliers</li> <li>Have access to the auditor's management letter on internal control</li> </ul>	<ul style="list-style-type: none"> <li>Look for presence of board as it improves the firm's governance rating</li> <li>Perform public search on reputation of directors, especially those on audit committee</li> <li>If the loan is very large, may request a meeting with auditor and/or copy of auditor's management letter on internal control</li> </ul>		<ul style="list-style-type: none"> <li>Prefer a mix of insiders and outsiders on the board</li> <li>Have access to the auditor's management letter on internal control</li> </ul>
<b>Adjust for tax shields</b>	Yes	Review—not clear if they have expertise to make such adjustments	Review—not clear if they have expertise to make such adjustments	No
<b>Related-party transactions</b>	Adjust to fair market value	Review	Review	Review
<b>Adjust management's compensation to fair market value</b>	Yes	No adjustment made, but a limit on compensation is stipulated in a covenant	No, but managerial pay is deducted in financial calculations	No
<b>Adjust capital structure</b>	Yes, adjust to optimal level	Add unrecorded debt (e.g., leases)	No	No
<b>R&amp;D</b>	Appraise value	Ignore—it is not liquid	Ignore—it is not liquid	Approve/monitor investments
		Deduct from assets when inputting data into model	Deduct from assets when inputting data into model	
<b>Proposed capital expenditures</b>	Review and has to be approved by board (which they control)	Review and want the board's strategy or operations committee to monitor and approve capital expenditures	Review	Conduct approval process on capital expenditures

model inputs and outputs. Bankers (like private equity) saw obtaining audited financial statements as just one part of a due diligence process. For example, a banker said:

Getting assurance is just the first step in a due diligence process. Many times financial information is not relevant anyway and the more important information comes from appraisals of real estate, tenant lease contracts, review of IP policy for tech firms, etc. Often this more “tailored” information such as appraisals and rent/tenant contracts are more informative than general purpose financial statements that come many months after year end. (Banker 4)

The banks in our study require companies to submit extensive financial information so the client company can be monitored continually (see column 2 in Table 3). 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 the purpose and source of financing.

Bankers mentioned the importance of having clarity in the notes to the financial statements, and the need for consistency in the application of GAAP. They were keen to know if there had been any changes 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, banks 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. None of our bank participants put any weight in their model on the quality of accounting, the quality of the auditor, or any direct accounting variables.

*Bonding Agencies* We interviewed two bonding agency employees and examined one detailed data input worksheet. The bonding agencies (surety companies) in our study were subsidiaries of insurance companies that primarily provided bonding coverage to construction companies though they had other clients as well. The main risk to these agencies is that a bank may refuse to renew a loan for a construction company, and then the construction company cannot complete a bonded contract.

Table 3, column 3 shows that our bonding agency participants also reported themselves as being keen followers of benchmarking, reviewed the company’s compliance with debt covenants, 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, capitalized R&D, and related-party assets. The schedule also had a section with the heading '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. Again there was no explicit assessment made of accounting or auditor quality.

*Directors* We interviewed three directors, all Chartered Professional Accountants<sup>11</sup> who had served as CEOs of various companies, and currently served on boards of both publicly traded and private companies. The directors claimed that they get more 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 (e.g., by product line, geographic location), cash flow generated from operations (especially 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 (see column 4 in Table 3). The focus on cash flows suggested only a limited role for GAAP, and hence for an audit.

All users were very interested in projected and actual cash flow (see row 1 in Table 3). All users also sought information from other sources to triangulate financial reports with non-financial reports. We observe that users appeared to have only limited use of and faith in audited accounting numbers. As we expected, agents who contract directly with private companies have direct access to a wealth of internal information about the company. They are not as reliant as public company shareholders on general purpose financial statements to provide relevant information for decision making. In some countries such as Canada, a separate private company GAAP has been created to cater to the more limited information needs of users of private company financial statements.

It was troubling to see that users such as banks appeared to pay no explicit attention to the accounting policies used by companies,<sup>12</sup> or have any notion of accounting or audit quality included in their models and spreadsheet analyses.

<sup>11</sup> Canadian accountants have to work in public accounting and have three years of experience as auditors prior to becoming Chartered Professional Accountants; all three directors had started their careers as auditors in Big 4 firms.

<sup>12</sup> There is a large body of literature on conditional conservatism in accounting and how this is driven by debt markets (drawing on the work and methodology of Basu (1997)). Perhaps the companies in our sample are too small to receive attention from banking specialists who process accounting policy choices or judge the quality of accounting.

## CONCLUSIONS

In private companies, we find that CFOs and directors value auditor expertise and treat their external auditors as a business partner and as part of their internal control system. The focus and scope of the audit plan (including audit hours, risk assessments, staffing, timing, and location of procedures) are all subject to negotiation with the CFO and corporate directors so there is a 'fit' between the risk perceived by the auditor and the risk perceived by these other agents. We observe that these audits are oriented towards detecting error, not fraud, and the focus on 'fit' detracts from a general sense of auditor independence. Consequently, there is little randomness/unpredictability in the auditors' work (Johnson *et al.*, 1993). Surprisingly, regulators have sought to carry these features over to the public market where there is a much stronger emphasis on auditor independence. Auditing standards require public company auditors to submit their detailed audit plans for review and approval by the audit committee (thus eliminating any chance for the auditor to surprise management to disrupt fraud). It is hardly surprising that external auditors seldom detect fraud (Dyck *et al.*, 2010). We wonder why regulators preserve this feature of private audit markets since they purport an interest in improving the effectiveness of the external auditor in detecting fraud and promoting auditor independence.

We find that users of audited financial reports in private markets have access to extensive private information about the quality of internal controls, the governing processes of companies, the capabilities of management, and the skills of audit partners/managers (so private company audit is not a credence good?). Regulators have sought to convey the same signals to public company shareholders by requiring public disclosure on going concern, quality of internal controls, name of the audit partner, auditor risk assessments, significant audit matters, and restatements of errors in financial reporting. For the most part, regulators are simply trying to make available to the public signals generated and used by users of private company audits (Watts and Zimmerman, 1983).

Incentives for independence in private company audits appear to be much weaker than commonly thought in the literature. Indeed, we are often puzzled by the frequency of audit failures in public company audits. This is perhaps because agency theory makes it seem like auditor independence should be a major attribute of auditing. An understanding of how weak private incentives are may help either change the practice of auditing (especially the auditor appointment process), or induce a rethinking of the relative importance of auditor expertise vis-à-vis auditor independence.

A field study has its advantages and limitations. The sample size is small and most of our data are qualitative. Even though our participants are experts involved in business, and were forthcoming, we have only a small sample of interviews with CFOs, auditors, bankers, private equity firms, bonding agencies, and corporate directors. Even if they tell us truthfully what they believe, their revelations might tell us only what is salient to them; they may not be consciously

aware of all aspects of their business environment. Future studies should strive to obtain larger samples of each type of subject, tape record their interviews, and follow a more unstructured discussion to try to delve further into this complex issue of comparing and contrasting auditing in private and public companies.

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## APPENDIX 1

### SOURCES OF DATA

Source	Interviews	Documents
<b>Private equity Bankers</b>	2	<ul style="list-style-type: none"> <li>• One detailed quality of earnings analysis report</li> </ul>
	4	<ul style="list-style-type: none"> <li>• Bank 1 provided a lending contract</li> <li>• Bank 1 and Bank 2 each provided:                             <ul style="list-style-type: none"> <li>◦ a risk-rating model description,</li> <li>◦ a client's financial statements,</li> <li>◦ a data input worksheet, and</li> <li>◦ an example of model output</li> </ul> </li> </ul>
<b>Bonding agencies</b>	2	<ul style="list-style-type: none"> <li>• One detailed example of:                             <ul style="list-style-type: none"> <li>◦ a client's financial statements and</li> <li>◦ data input worksheet</li> </ul> </li> </ul>
<b>Directors</b>	3	<ul style="list-style-type: none"> <li>• None</li> </ul>
<b>CFOs</b>	11	<ul style="list-style-type: none"> <li>• One Audit Proposal document (RFP) prepared by Company 1</li> <li>• One summary prepared by Company 6 for the board explaining auditor choice after conducting an RFP</li> </ul>
<b>Auditors</b>	5	<ul style="list-style-type: none"> <li>• Three audit bids submitted by Big 4 Firms A, B, and C in response to the RFP issued by Company 1</li> </ul>
<b>Total</b>	27	

## APPENDIX 2

### SCRIPT FOR DISCUSSION WITH NON-AUDITOR PARTICIPANTS

1. Industry type:
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 the auditor?
8. Time series of audit fees since hired (if possible)?

9. Who are users of financial statements? (bank, board (insiders, outsiders), suppliers, customers, bank, employees, tax, regulators, governments, internal decision making)
10. What do they do with the financial statements?
11. What do you want from the 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 the 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 the partner has to rotate off, what would you look for in the next partner?