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Literature review: do private firm audits serve a different purpose?

Mahmoud Gad
m.gad1@lancaster.ac.uk
Lancaster University

Robin Litjens
h.j.r.litjens@uvt.nl
Tilburg University

Jeroen Suijs
suijs@ese.eur.nl
Erasmus University

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1. Executive summary

The Dutch market for mandatory audit services is heterogenous and includes publicly listed and private firms. While private firms dominate the market, existing audit research focusses primarily on listed firms where audit demand originates from external stakeholders such as shareholders assisting them in the monitoring of management. This is surprising as private firms represent a significant portion of the economy in most countries.

Private firms generally face different incentives in terms of accounting and auditing demand. For example, private firms that are not run by owner-manager may have agency conflicts that drives the demand for audit. However, in private owner-managed firms external audit demand can arise from other, more internal, factors that are difficult to observe and less well understood, such as compensation for lacking internal controls. Legislators across the world seem to acknowledge this variation and mandate audits to a varying degree, for instance dependent on private firm size. Yet, institutional heterogeneity is large, varying from mandating audits for very few (e.g., United States) to all (e.g., Sweden) private firms.

Furthering our understanding of internal value factors of private firm external audits and their effect on audit pricing, audit effort and audit quality is therefore relevant. It can assist regulators in determining the scope (which private firms) and features of a private firm audit (e.g. independence regulation, exclusion of certain non-audit services). Understanding internal value factors can assist auditors and audit firms in how to price and ‘produce’ private firm audits and the effects of these decisions on audit quality.

2. Research Synthesis

2.1 Prior literature and hypotheses

Like many European countries, the Dutch market for mandatory audit services is heterogeneous and includes both publicly listed and private firms.[1] Lennox and Li (2012) underscore the significance of private firm audits by indicating that in the United Kingdom public companies account for only 1% of the total audits performed. This is similar for the Dutch audit market.[2] While private firms dominate the market, existing audit research focusses on listed firms assuming demand for audit services originates from separation of ownership (shareholders) and control (managers), labelled external agency cost.[3]. In addition, the approach to private firms' audit regulation generally uses a "one size fits all approach" and thus fails to consider potential differential purposes of an external audit across private firms.[4]

How does the demand for audit services arise? A key economic feature of public firms is separation of capital suppliers (shareholders and debtholders) and managers that run day-to-day operations. For listed firms, the group of stakeholders is usually large and diverse, and these stakeholders do not have direct access to the firm to monitor its activities (Rennie et al., 2003; Lennox and Pittman, 2011). Building on this separation, agency theory is the basic framework to explain *institutional* demand for external audits; audited financial statements are regarded as a cost-effective contractual response to agency cost (DeAngelo 1981; Watts and Zimmerman 1976, Jensen and Meckling 1976, Watts and Zimmerman 1986). [5]

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[1] We focus in this literature review on for profit firms, but we acknowledge that there is also a significant mandatory audit market in the Netherlands for not-for-profit institutions.
[2] There are about 150 – 200 listed firms and about 10,000 medium-sized and large firms that require an external audit.
[3] For instance, see Chow (1982), Francis and Wilson (1988), DeFond (1992), Anderson et al. (1993), Willenborg (1999), Pittman and Fortin (2004).
[4] For instance, in the Netherlands all private firms that meet certain size criteria have a mandatory external audit and this audit is subject to the same regulation. Given a certain size of a private firm, this ignores potential heterogeneity in the internal and external value of an audit.
[5] For a literature review on public firm audit market research, see, e.g., Francis (2004) and Knechel et al. (2013).

In contrast, for private firms the group of external stakeholders is relatively small and their close relation with firm management enables them to request information directly and to closely monitor the firm's activities. Therefore, private firms have little capital-market pressure to hire (high quality) auditors. Unsurprisingly, research documents greater heterogeneity in reasons driving audit demand in private firms.[6] Private firms could demand auditing for various reasons: reduce agency costs (Dedman et al. 2014), facilitate bank lending (Peek et al., 2010), reduce the chance of material errors (Collis et al. 2004; Clatworthy and Peel, 2013), to get useful advice (Collis, 2012), for efficient running of the company (Page, 1984). The literature has shown that private firms auditing pays off. For example, Kausar et al (2016) argue that the choice to obtain an audit by private firms can convey information about firm's future prospects to external financiers. Accordingly, they show that these firms significantly increase their debt, investment, operating performance, and investment efficiency.

This variation in audit demand by private firms is reflected in the significant *institutional* variation regarding mandatory audit regulation for private firms over the world. For instance, until recently, various Scandinavian countries required a mandatory audit for all private limited liability firms regardless their size.[7] In other European countries, like the Netherlands, a mandatory audit is required for medium-sized limited liability firms.[8] Australia mandates an audit for large private firms (Carey et al., 2000) and in the United States a mandatory audit is required for companies with widely dispersed ownership (more than 500 shareholders).

In line with lower external value of the audit, research shows that few private firms employ Big-4 auditors (Hope et al., 2013). There does not seem to be a Big-N fee premium

[6] For an overview of private firm audit research, see, for instance, Vanstraelen and Schelleman (2017) and Minnis and Shroff (2017).
[7] Denmark (till 2006), Finland (till 2008), Norway (till 2011), and Sweden (till 2011).
[8] Firms are considered medium-sized if two of three of the following criteria are met during two consecutive years: total assets are greater than 4.4 million euro, revenues greater than 8.8 million euro, and the number of employees is greater than 50.

(Chaney et al., 2004) and an industry specialization premium.[9] Esplin et al. (2016) suggests quality considerations in auditor selection in the private firm audit market is amongst other things related to the ability to deliver additional non-audit services.

Other arguments, related to internal characteristics, are put forward to explain demand for an independent audit in private firms (Knechel et al. 2008 pp. 69). For instance, private firms seek audits as compensatory control systems for the organizational loss of control (Abdel-Khalik, 1993), as a remedy for weaknesses in internal controls (Simunic and Stein 1987, Carey et al. 2000), to improve operational efficiency and effectiveness (Svanström and Sundgren 2012), and outsourcing of financial accounting tasks (Gooderham et al. 2004). All these arguments speak to the internal value of the audit. Prior research essentially focused on the internal value or the external value of the audit of public firms in isolation, relying on publicly available data to proxy for the internal value of the audit (e.g. Abdel-Khalik, 1993; Knechel et al., 2008).[10] We add to this literature by creating a comprehensive empirical test for private firms using proprietary data to capture the internal value of the audit and by using public firms as a benchmark. Our first test therefore focuses on whether the pricing of the internal value of the audit differs between public and private firms:

> **H1**: Compared to public firms, there is a higher association between the internal value of the audit and audit pricing for private firms*. (Audit Pricing Hypothesis)*[11]

[9] Evidence is mixed, i.e. Lennox et al (2012) find that the big-N premium remains.
[10] This argument also applies to theoretical literature that exclusively seem to focus on audit quality of publicly listed firms in relation to, e.g., audit pricing, auditor-client selection, audit quality and legal liability, and auditor independence. In these papers, the audit serves a single purpose, i.e. verification/assurance of the financial report. The only exceptions in this respect that we are aware of are Kornish and Levine (2004) and Lu and Sapra (2009). In these studies, one can interpret the external audit to serve multiple purposes: there is an audit committee that hires an auditor for assurance purposes and firm management can hire the auditor also for non-audit services (NAS). The NAS-fee can serve to 'bribe' the auditor to obtain a clean opinion on the financial report. These studies, however, do not distinguish between different types of firms, i.e., they do not model the differences in PIEs, POBs and OMBs. Hence, these studies do not provide insight on our research question whether POBs and OMBs would buy different audits compared to PIEs.
[11] The hypothesis is hampered by the fact that the auditor is not allowed to provide non-audit services to public firms. However, we are interested in the association between audit pricing and the internal value of the audit. Audit pricing therefore only captures fee for audit services and not non-audit services. This biases against us finding results. In addition, we focus on the subset of private firms and test the hypothesis: For private firms, audit pricing varies stronger with the internal value of the audit than the external value of the audit.

Next, we will turn to audit production decisions to characterize differences in the audit. Under the assumption of a competitive audit market, efficient audit production can be viewed as a standard constrained cost minimization problem for a fixed level of assurance (e.g. O'Keefe et al. 1994; Dopuch et al. 2003). The amount of input that an auditing firm employs will rely on trading off the costs and benefits of employing that input (Wallace, 1981). However, if private firms care about the internal value of the audit we can expect auditors to respond to these clients' needs by adjusting audit production decisions. This latitude exists because auditors can use professional judgment to approach the audit (e.g. controls-versus-substantive approach). In line with this conjecture, prior empirical research documents differences in the association between engagement characteristics and auditors' resource allocations (Hackenbrack and Knechel, 1997).[12] Audit production research was further extended by examining the relative efficiency in audit production (Dopuch et al. 2003 ; Knechel et al. 2009).[13] The evidence suggests that there are some inefficiencies in audit production that could be associated with demand for the internal value of the audit, i.e. clients with subsidiaries, reliance on internal controls, and clients receiving tax services (Knechel et al. 2009). To sum up, we expect variation in demand to be observed in audit production decisions (labor-mix).. This leads to the following hypothesis:

> **H2**: Compared to public firms, there is a higher association between the internal value of the audit and the labor mix of the audit for private firms *(Audit Needs Hypothesis).*

Finally, given mandatory audits for private firms in the Netherlands, we assess whether and to what extent differences in the audit production translate into differences in audit quality. We state this hypothesis in the null assuming audit production decisions, effectively representing variation in the product audit, are not associated with audit quality:

[12] For literature review and an integrated view on audit markets, fees and production, see De Martines et al. (2011).
[13] Research has employed efficiency frontier techniques such as Data Envelopment Analysis (DEA) and Stochastic Frontier Analysis (SFA) (see Dopuch et al. (2003) and Knechel et al. (2009) for further details).

H3: There is no difference in association between the labor-mix of the audit and audit quality between public and private firms *(Audit Quality Hypothesis).*

2.2 Relevance to practice

Using archival data to systematically document to what extent the private firm audit market differs from the public firm audit market on institutional, economic and behavioural factors enhances practice on policy debates. First, the Federation of European Accountants (FEE) states, for instance, that a review with a limited level of assurance could suffice for certain smaller private firms (FEE, 2016).[14] In contrast, this may also lead to lower-quality financial reporting (Thompson 2014). Survey research (Minnis and Shroff, 2017) shows that standard setters view the benefits of audit requirements as exceeding the cost more often than firms whereas firms view mandatory audits as unnecessary. If, and to what extent, (owner-managed) private firm audits should be mandated depends on the deadweight losses of regulation. Taken to the extreme, heterogeneity in agency cost of various stakeholders of private firms (shareholder, debtholder, supplier, customer, tax authorities) could lead to firm-specific cost-benefit analyses for audit demand. This would imply that audit regulation should be conditional on firm specific cost-benefit trade-offs. Because these trade-offs are unlikely to be publicly observable, such regulation is practically infeasible. Our analyses might reveal clusters of firms with similar characteristics and a similar demand for audit. Consequently, audit regulation could differentiate across these clusters using publicly observable characteristics. Second, given the potential internal value of independent audits, it is not clear if and whether imposing independence regulation in the (owner-managed) private firm audit market is beneficial. If so, at which level should these institutions be enacted, e.g., audit firm

[14] In the Netherlands, the same practitioners' debate is going on. Practitioners are proposing to abolish the mandatory audit of private firms in the Netherlands (Knoop and Piersma, 2017).

or audit partner rotation. Should these independence rules apply to all private firms or a subset of firms? The comprehensive empirical analyses described in this research proposal can assess the drivers of audit quality and whether they differ between different types of firms.

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