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Practice note: Is the internal value of the external audit greater for owner-managed businesses than for public interest entities?

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The research study by Gad, Litjens en Suijs relates to the question of the Foundation for Auditing Research whether there exists a need for 'different audits for different purposes'. Does the external audit of a public interest entity require a different approach than the external audit of an owner-managed business? In order to answer this question, it is appropriate to analyze the differences in value of the external audit for a public interest entity versus an owner-managed business.

A public interest entity has many external stakeholders, among which are the stockholders. The company is accountable to the stockholders for their invested capital. In the Anglo-Saxon model, this is an important reason for the existence of the external audit. The external audit provides assurance that the contents of the annual report are reliable.

But what stakeholders does an owner-manager of small business need to inform? The owner-manager himself/herself is extremely closely involved in the day-to-day business of his company. Of course, investors will value an external audit, but it is debatable whether a similar level of assurance is needed as for the audit of a public interest entity. The expectation is that, on average, the external value of an audit of an owner-managed business is relatively lower than for a public interest entity and the internal value is relatively higher. Here, the external value of the external audit is viewed as the value of the external audit for stakeholders (particularly stockholders and debt providers). The internal value of the external audit is the value of the external audit for the company itself.

The relative external and internal value of the external audit may vary. However, the legal obligation for the external audit applies to a broad range of organizations. Given the reasoning in the previous paragraphs, it can be argued that an owner-manager will tailor the external audit as much as possible in order to increase the internal value of the audit. For example, the relative value of consulting/advice will be higher than for a public interest entity.

The question posed by FAR is whether external audits differ between public interest entities and owner-managed businesses and whether auditors need different qualities to comply with different conditions. To study this question, we have chosen to look at so-called 'revealed preferences': what is actually going on in practice? We examine the internal and external value of the external audit. This demands data concerning the production function of the external audit, for example hours spend on the audit. On what tasks auditors spend relatively more or less time? How is time allocated between audit versus non-audit tasks? Is the external audit budget structurally different between owner-managed businesses and public interest entities? Based on these data, the research team can analyze whether auditors approach the external audit differently for owner-managed businesses and public interest entities.

The research team would like to study three hypotheses.

In the first hypothesis, researchers examine whether the relationship between the internal value of the external audit and the fee that is paid for the external audit is stronger for the owner-managed businesses than for the public interest entities. The basic idea underlying the hypothesis is that price of the external audit of owner-managed businesses is mainly driven by the internal value of the external audit.

In the second hypothesis, the so-called 'labor mix' will be studied. If owner-managed businesses are more interested in internal value of the external audit, it is also to be expected that more hours will be spend on tasks that contribute more to the internal value. Hopefully, data will be available on the numbers of hours spent on assurance versus, for example, consulting/advice. The hypothesis states that the labor mix will be different for owner-managed businesses and public interest entities: for a greater relative internal value, the labor mix will be different than for a smaller relative internal value.

The third hypothesis concerns the relationship between the labor mix and audit quality. If the labor mix is different (see second hypothesis), then the audit is conducted differently. However, the purpose of the external audit is to provide assurance on the 'figures'. If there exists limited difference in audit quality based on labor mixes, this may ask for reconsiderations. Within a certain group of companies, it seems logical that the labor mix influences audit quality. However, it is important to study whether that also holds between different types of companies: maybe a different labor mix does not have a negative impact on audit quality.