

How Do Market Agents Assess Audit Quality?

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ABSTRACT

The Public Company Accounting Oversight Board (PCAOB) in the U.S. regulates auditing and seeks to promote its quality, a difficult-to-define concept. To understand how agents involved in private companies think of audit quality, we interview their CFOs, auditors, bankers, board members, bonding agencies, and some private equity investors. We find that a variety of agents demand an audit while retaining their scepticism and seeking independent corroboration of what they learn from the audited financial statements. Management selects the auditor. Audit Quality is assessed based on the degree to which the audit plan (inputs and risk assessment processes) aligns with the views of management and directors. In addition, output measures such as number of errors and the time when they are adjusted, tax advice, controls/governance advice and auditor candor are used to assess audit quality. As judged by users, quality depends on a combination of inputs, processes and outcomes of audits.

Keywords: Sources of demand for audits, regulation of audits, auditor selection, audit quality.

Journal of Economic Literature (JEL) Classification System: M42 – Auditing.

1. Introduction

A key mandate of the Public Company Accounting Oversight Board (PCAOB)¹ is to oversee the audits of public companies and to protect investors in public capital markets. Yet the quality of audit has no official definition. The PCAOB has sought public input to help develop a set of Audit Quality Indicators (AQI- see PCAOB 2015) that can be used to measure audit quality. These indicators are grouped under three headings of professionals (largely focused on competence/expertise), process (tone at the top and independence), and results (quality of financial statements, errors, fraud, internal control). While these measures have been a staple of regulatory debates over decades (Francis 2011; Knechel, Krishnan, Pevzner, Shefchik and Velury 2013; Mautz and Sharaf 1961; Zeff 2003), our understanding of how investors and other users of financial statements assess audit quality, and how much reliance they place on audited financial statements, remains limited.

In this paper, we report on a field investigation of how agents who produce and/or use audited financial statements assess audit quality, and how they use the resultant financial statements. To isolate them from the consequences of regulation, we limit the study to demand, purchase and supply of audit services for private (i.e., not publicly traded) companies. Since such companies are not bound by the audit requirements of securities laws, we are able to address the following questions: 1) Who demands auditing in the market for private capital? 2) Who chooses the auditor and how? 3) How do companies and users assess audit quality? 4) How are audited financial reports used in making decisions?

¹ The Canadian equivalent is called the Canadian Public Accountability Board (CPAB).

These questions are motivated by debates about the nature and consequences of regulation of auditing by the state. For the past eight decades, publicly traded firms in the United States, Canada and many other economies have been required by law to be audited by independent public accountants. This federal mandate, combined with the easier access to data, have focused much of the audit research literature on studies of public companies, and have underemphasized the private incentives for demanding an audit (Jamal 2008; Jamal, Maier and Sunder 2003). Studies of public company audits can only reveal the combined consequences of private incentives and regulation, although the observations are often attributed to regulation alone. Since archival evidence with large samples on private demand for audit from agents other than creditors has been difficult to obtain despite early attempts by Chow (1982) and Abdel-Khalik (1993), economic analysis of private audit demand has remained largely focused on the market for debt (Allee and Yohn 2009; Blackwell, Noland and Winters 1998; Leftwich 1980; Lennox and Pittman 2011; Minnis 2011; Senkow, Rennie, Rennie and Wong 2001. However, see Dedman, Kausar and Lennox, 2014 for 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. Little is known about the demand and use of audited financial statements by agents other than creditors.

Requiring auditors to be competent is unexceptionable; whether the cost of rotating audit partners (Tan 1995) or audit firms (Fiolleau et al. 2013) and potentially diminishing their competence is worth the potential gain in their objectivity has been the subject of much regulatory debate. Research findings do not generally support the notion that auditor tenure diminishes audit quality (Myers, Myers and Omer 2003).

Effectiveness of regulation of the auditor engagement process in preserving their independence is also an open question. Since 2002, the U.S. Sarbanes-Oxley Act (SOX) requires audit committees consisting of independent members of the boards of public companies to appoint the outside auditors and to supervise their work. Independence of such committees, and indeed the boards, from the management is subject to doubts (Cohen, Krishnamoorthy and Wright 2010; Gendron, Bedard and Gosselin 2004, Gendron and Bedard 2006, Dhaliwal, Lamoreaux, Lennox and Mauler 2014), leading some scholars to suggest that no company should be allowed to select its own auditor (Mayhew and Pike 2004, Moore, Tetlock, Tanlu and Bazerman 2006).

Whether auditor independence is compromised by sale of non-audit services to the audit clients has attracted divergent answers. Mautz and Sharaf (1961), and Zeff (2003) stand on one side and argue that sale of non-audit services diminishes perceived and actual independence of auditors, while Dopuch and King (1991), Francis, Reichelt and Wang (2005), and Kinney, Palmrose and Scholz (2004) are on the other side arguing that there is no independence impairment. In the accounting literature, there is also a concern about whether investors are fooled by earnings management or not (Ball 2013) and the extent to which auditors properly restrain or fail to restrain earnings management (Kadous, Kennedy and Peecher, 2003; Nelson, Elliott and Tarpley, 2002). With the mandatory audit regime for public companies in place for seven decades, the welfare consequences of this regime cannot be assessed by confining our attention to public companies; a study of private companies outside the mandate adds valuable insights.

The present field study gathers primary observational data on variables that are not normally included in the standard models of auditing, and affords the opportunity to gain insights into

alternative sources of demand for audit, interactions between audit and non-audit services provided by the audit firms, and new stylized facts and explanations to broaden our understanding of auditing. The evidence gathered highlights several areas where the extant academic models and assumptions deviate from existing practice in important respects. Some conjectures about implications of the findings for regulation of audits in public markets are also included.

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

Our results indicate that private demand for audit comes from a variety of agents such as bankers, directors, bonding [surety] companies, customers, employees, internal governance needs, management, other lenders, other (non-securities related) regulators, private equity firms, owners hoping to attract prospective buyers, and vendors. Management is especially responsive to demands from suppliers of equity capital by hiring a Big-4 auditor. When demand for an audit comes from other sources, usually a bank, management is reluctant to provide audited (or any) financial statements and may only hire a Non Big-4 firm at lower cost. Banks who ask for an audit report face resistance from client companies. Eager to avoid losing clients in a competitive loan market, banks tend to refrain from pushing borrowers too hard, and often accept review reports, or a notice to reader engagement² even when the size of the loan exceeds their normal threshold for requiring an audit. Companies are extremely reluctant to provide audited financial reports to their vendors. A vendor has to be a major shareholder or be involved in significant risk sharing arrangements with the company to be given such access.

In all 11 interviewed companies, management, usually the President or the CEO selected the auditor. Other financial executives—CFO or controller—were sometimes involved in the interview process, but they did not make the final choice. 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. In one company, the board chair was involved in the selection process, but the CEO clearly decided. In a second company, management decided to change the auditor and prepared an after-the-fact memo for the board to justify the decision. The board accepted the

² Among the range of assurance services provided by audit firms, audit and review reports provide the highest and an intermediate level of assurance respectively. An accounting service provided by audit firms is not considered to be an assurance service, but there is some chance that a user may believe assurance is being provided because the name of an audit firm is on the report. Professional regulations require the audit firm to attach a “Notice to Reader” to inform the users that no assurance work has been done on such accounting engagements.

recommendation and voted to hire the new audit firm. In this case at least, the board can be said to have “overseen” the process, but it was not actively involved in interviewing or selecting the auditor.

The choice of the auditor was primarily based on personal relationships of individual audit partners with a senior member of management or the board chair. CFOs and other users thought that services of all Big-4 audit firms were undifferentiated commodities and the selection decisions were heavily influenced by attributes of and relationships with individual partners. Since there was little perceived audit (or accounting) expertise-based differentiation, ability to deliver other services (tax and consulting) and relationship-based variables (responsiveness, fit, “makes me feel special”) had a dominant role in the auditor selection process. Instead of the audit leading to an advantage in selling other services, capabilities in delivering other services often drove the auditor selection. Audit quality is assessed based on four key variables: comfort with the accounting numbers/systems, business advice, price, and connections with external networks. The auditor is clearly seen first as an accounting expert who is available 24/7 to provide advice on any accounting issue that arises. Responsiveness of the auditor was mentioned by every CFO as an important attribute. CFOs, bankers, and private equity owners discuss accounting issues directly with the auditor and assess the auditors’ depth of reasoning around complex accounting issues. CFOs and board members also want financial reports to be free of error, disclosures to be proofread, and to treat the auditor as part of their company’s control system, that affords them some personal protection. They want advice on internal control matters, sometimes on governance, and assessments of the technical capability of the company’s finance staff.

CFOs and board members care deeply about the audit plan and the auditor is not free to allocate time and levels of expertise to whichever accounts (s)he deems important (as required by auditing standards). CFOs and users also want the auditor to provide general business advice on “anything that will help the company to be more profitable and more efficient.” Capability to provide business advice is a major selection consideration for auditors; therefore business advisory service capability tends to drive auditor choice, instead of the other way around. All CFOs in our sample wanted auditor involvement in tax compliance and tax planning. CFOs and users welcome audit firm efforts to connect them to broader industry networks including alternative sources of capital, potential customers and industry conferences, and other organizations such as tax authorities. There is little concern about conflict of interest or spillage of information to competitors. Bankers, private equity purchasers, and even board members view reliability and validity of audited financial statement numbers with a skeptical eye. Since they have access to the auditor, these agents can directly examine audit working papers and/or ask questions directly to the auditor about internal control, the reliability of the numbers, and question the assumptions behind them. If the users are going to rely significantly on specific accounting numbers, they often hire another expert to examine them in more detail. Audited numbers are often adjusted for biases arising from tax considerations, related party transactions, and various non-commercial arrangements and/or improper capital structure. Some known deficiencies of accounting (e.g., off-balance sheet leases) are adjusted for as part of the normal operating template used by banks. Financial information is combined with a variety of non-financial indicators obtained from other sources, making it unlikely that any single financial statement number has a decisive impact on the users’ decisions. We see little evidence of users of private company financial statements being misled by earnings management

In the private market, users are sophisticated, corroborate audited financial statements with information from other sources, request additional information from management, and hire experts to probe information in more detail as needed. There is no market failure here. However, managerial reluctance to share information widely still allows the possibility to demand a mandatory audit on public interest grounds.

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

2. Demand for Private Audits and Auditor Regulation

Agency theory posits a potential conflict of interest between management of the firm and all other agents (shareholders, creditors, suppliers, customers, employees) who contract with the firm (Jensen and Meckling 1976). An auditor can help facilitate contracting by examining management's financial representations. A key requirement for an auditor to be useful in this setting is that the auditor should be willing to disclose instances where management is not being truthful, that is, by being independent of management (Watts and Zimmerman 1983). This basic idea was extended by DeAngelo (1981a, b) to add expertise as an additional variable whereby investments by the audit firm in better fraud and error detection technologies could also yield a higher quality audit. Thus from an economic perspective, audit quality has two key dimensions: independence and expertise, and these dimensions are important in both private and publicly regulated audit markets. However, these variables are input variables, and PCAOB (2015) as well as many researchers also use output measures (quality of financial statements (accruals),

restatements, going concern, fraud) as indicators of audit quality. In theory, all non-management agents could demand an audit. It may be possible to argue on public interest grounds that it is efficient to make audits mandatory for all corporations as was required by law in the U.S. and Canada prior to corporate law reforms in the 1990's which exempted private corporations from legal requirements to be audited.

An alternative formulation of demand for audit comes from a sociological perspective. According to institutional theory (Meyer and Rowan 1977; DiMaggio and Powell 1983), organizations adopt practices which make them look appropriate and legitimate, regardless of whether they increase economic efficiency. Organizations manage uncertainty by decoupling activities, and ceremonializing/ritualizing inspection and evaluation by both internal and external constituencies. Confidence is maintained by avoidance, discretion and overlooking of inconsistencies and discrepancies. Appeals are made to the good faith of participants, and this good faith is used to shield the organization from detailed scrutiny (Power 2003). This means that audits will be ritualized and ceremonial (Pentland 1993) rather than detailed examinations looking for fraud and error. Organizations come under pressure to mimic other successful organizations; so adoption of an audit by one firm can lead to other firms in its industry or supply chain coming under social pressure to also be audited (Cohen, Krishnamoorthy and Wright 2008). In the limit, this can lead to a regulatory demand for audit, as all corporations can be required to be audited to maintain legitimacy, regardless of whether they are public or private.

Since both the economic (e.g., agency theory) as well as the sociological (e.g., institutional theory) perspective predicts private incentives for organizations to be audited, and in the limit both theoretical perspectives can be used to make a public good type argument for mandatory audit, it is not surprising that in the decades preceding the enactment of the U.S. federal

securities laws in 1932-33, accounting firms provided accounting, tax, and other business advisory services in addition to auditing (Zeff 2003). About 82 percent of publicly traded companies on the New York Stock Exchange (NYSE) had engaged an auditor and issued audited financial statements to the public prior to the advent of the legal mandate to hire an auditor (Benston 1969). The federal securities laws imposed a mandatory audit requirement for publicly traded companies raising the rate of public company audits from 82 percent to 100 percent. Eight decades later, many think that public companies hire auditors to meet this regulatory requirement (especially since audit textbooks depict demand for auditing as coming from regulation). However, historical evidence suggests otherwise; there were other market-derived and/or legitimacy derived incentives underlying the demand for audit. Our field study of private companies suggests that those incentives have not disappeared over time.

3. Research Method

We collected data by interviewing participants (for about an hour each) and requesting primary documents as examples of the decision processes they described to us. A managing partner of a Big-4 accounting firm assisted us by identifying a set of private companies (across Canada) that had recently hired an auditor. Through personal contacts of the authors, 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 various important users (banks, private equity firms, bonding agencies, directors). Using personal networks of the authors, and introductions made by the CFOs, we recruited 16 members of these user groups to participate in the study. While the sample size is not randomly chosen, our participants are experts, and the number of participants is consistent with other field studies in accounting (Hermanson, Tompkins, Veliyath, and Ye 2012). In addition, our participants provided written

supplementary documents that extend the information set significantly beyond what we learned from them in the interviews.

The interviews with CFO's and auditors about how auditors are chosen by private companies and the RFP process generate insights very similar to those documented in prior studies of how public companies appoint auditors (Cohen et al. 2008; Fiolleau et al. 2013). We are also able to triangulate comments provided by CFOs and audit partners by having them respond to a common RFP case study. In addition, relative to the U.S., the Canadian banking industry is extremely concentrated with 5 big banks dominating about 90% of the market, with the remaining market share spread among 6 regionally focused banks³. 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 extremely difficult to triangulate their responses given privacy and anonymity constraints.

Most interviews took place over the phone with two members of the research team present; both took extensive notes during the interview. Some face-to-face interviews also had two researchers present. Our participants come 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, Hermanson, Tomkins and Ye, 2014). We thus faced the prospect of having some participants being willing, and some unwilling, to be recorded. Our consent form allowed us to record the interview, but our first participant (a CFO) strongly refused to take part if the interview was recorded despite all the

³ 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.

confidentiality and anonymity safeguards in our consent form. We thus 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. Our real time field notes are the primary source of data in this research. After each interview, one of the researchers summarized the interview, while the second researcher edited and reviewed the summary. Any discrepancies were resolved by discussion between the two researchers, and a final version of the session summary was agreed on. In some cases, a short follow-up phone interview was conducted with a CFO and/or auditor to clarify discrepancies in understanding between the two researchers. Interviews and summaries were completed during ten months 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 we asked CFOs which focus on size, who/how the auditor was selected (independence), what services the company purchases from the auditor (independence), and more open ended questions such as what they want from the auditor and how they define audit quality. Table 1 focuses on identifying agency theory relevant variables such as the dominant user, the existence of a Board, 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. Topic headings for Table 3 are based on user comments about their reliance on cash flows, and agency theory related variables such as quality of management, governance and internal control, and adjustments made to the audited financial

statements. Data reported in the Tables was first input by one of the authors from the interview summaries. Then a student research assistant who was not familiar with the research issues being investigated in the study independently filled out the Tables. Then the author and 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 CFOs of companies (see Appendix 2). The questions were motivated by our four research questions 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, size and number of employees. These variables are generally used as proxies for magnitude of agency costs in the private company audit literature; 2) The next four questions (Q5-Q8) probed who chooses the auditor and how is the auditor selected. 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 next two questions (Q9-Q10) probed the demand for audit and what the participant's thought the users did with audited financial statements (which is important for understanding demand). 4) The next nine questions (Q11-Q19) were more open ended and probed how the participants assessed audit quality and included demand for other services (a proxy for agency costs), 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 advance⁴. The

⁴ To get research ethics approval at our University, the authors felt that we had to have a written script of questions that would be given to participants in advance of the interview. In addition, we felt that the first set of questions had to be quite specific before the interview could be opened up for a broader discussion.

script served as only a guideline for the discussion and allowed both sides to digress and pursue interesting avenues of discussion (Hirst and Koonce 1996). Four companies had gone through a request for proposal (RFP) process so we asked these companies for a copy of their RFP. Only one company provided a copy of their RFP. For this company, three of the Big-4 audit firms bid for the audit. We obtained a copy of each bid directly from the bidding firms, and interviewed the respective bidding partners to ascertain their understanding of what the company was looking for, and how they sought to differentiate themselves from the other Big-4 firms in competing for the engagement.

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

We also asked the users to provide primary documents illustrating the type of information they access from various sources (financial and non-financial) and the outputs of their models for a specific case. One bank provided a detailed loan contract, an example of a template used to input financial statement data into their model, an example of the other types of non-financial information they input into their models, and the output from their model. Another bank provided a detailed description of its decision model, the inputs (financial and non-financial) that went into the model, and a copy of the output. A bonding [surety] company provided a detailed example of what inputs they extract from a financial statement and what outputs they generate to guide their decisions. Three directors described the measures they use to guide their

understanding of the companies they are involved with. The consulting unit of a Big-4 accounting firm provided a detailed example of a “quality of earnings” analysis they would conduct for private equity firms showing a template of “adjustments” they look for. The provision of these private documents made it easier for us to have a meaningful and probing conversation with the participants, who were aware of (and had personally given to us) these extensive private documents. We provide summary statistics, interview quotes, and some tentative generalizations to communicate the rich and diverse data that we collected.

4. Findings

Who Demands an Audit?

Our respondents identified a dominant user who had motivated them to hire an auditor (See Table 1). Five companies identified the bank as the dominant user who demanded audited financial statements 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 (80 percent) chose Non Big-4 auditors, while one chose a Big-4 auditor. Four companies identified a desire to sell equity as the dominant reason for hiring an auditor. All four of these companies hired a Big-4 Firm as auditor. One company identified a customer as the dominant reason for hiring an auditor and hired a Non Big-4 Firm as auditor. One company identified another regulator as the dominant reason for hiring an auditor and hired a Big-4 firm as auditor.

Out of our 11 CFO participants, ten mentioned the Bank as a user, nine mentioned themselves as a user, 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. None made financial statements available to the general public.

The identification of users has a strong agency theory orientation. Frequent mention was made of the independence and expertise of the external auditor, and how management itself, as well as others, got comfort from an external audit. Management also made statements about how the auditor was an important part of their own internal control system, and how auditor recommendations for control improvements helped 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 auditor but they all claimed not to have one. 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. Bankers and bonding agencies had been 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. The loan size threshold for demanding an audit ranged from \$1-\$10 million, subject to other conditions such as personal loan guarantees and collateral. All four bankers (and the two bonding agencies) reported facing client resistance to requests for an audit (and its cost); competitive pressures often led them to relax their demand for an audit (Lisowsky, Minnis and Sutherland 2015 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)

Bankers thought of auditing services to be a commodity, and any differentiation in audit quality occurred at the partner level within firms and not across firms. Banks did not 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)

Bankers generally required an audit from companies who were growing and borrowing more funds. Their view was that such growth companies would eventually get lower debt costs as they were preferred clients, so there should be a correlation over time between being audited and lower cost of debt. Bonding agencies also offered pricing discounts based on volume of business, and not explicitly for audited financial statements.

[Insert Table 1 here]

Private equity firms and corporate directors responded quite differently to questions about their preferences for auditor. 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 thought there was a lot of variance within audit firms and that the specific partner also mattered a lot to determining the quality of service received. This pattern of responses is consistent with previous findings that companies who access equity markets tend to have Big auditors, whereas clients of Non-Big auditors are mainly reliant on debt financing (Chang, Dasgupta, and Hilary 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. Recent focus of the literature has been on whether audit committees actually carry out their legislated mandate effectively (Fiolleau et al. 2013), and whether management continues to have significant influence over the auditor appointment decision despite attempts made in SOX to minimize such influence (Dhaliwal, et al. 2014). In our setting, private equity firms and banks could easily play a decisive role in auditor selection if they had wanted to.

In private markets, there is no question that the management selects the auditor. Table 1 shows that in all eleven cases we examined, management (usually the CEO, but not the CFO)

had the dominant say in choosing the auditor. CFOs and board members also explicitly acknowledged that personal relationships were important in auditor choice. For the most part, the choice of auditor is made based on a pre-existing relationship that a member of management, or the board has with an audit partner. In some cases, another intermediary (e.g., lawyer) gave a recommendation, so the personal network of each audit partner is important in gaining audit engagements. Regardless of who made the introduction, management had the final say in auditor choice.

Participants in private markets made no mention about independence in this part of the discussion, possibly because various agents (private equity firms, bankers) can monitor the auditor directly. Private equity firms take board seats and can monitor the auditor directly. They receive the auditor's management letter indicating internal control deficiencies and recommendations, governance related comments, and errors detected and corrected. Likewise, bankers sometimes request copies of the auditor's detailed work papers, make queries of the auditor, and ask the auditor to explain their reasoning behind complex accounting estimates.

Private equity firms could easily influence an auditor choice⁵ (as could the bankers) but they chose not to do so. They were quite emphatic in claiming that they did not play any role in determining which auditor was chosen. These agents take the auditor's independence for granted, and want management to choose an auditor who they (management) will respect and listen to. Audit partners invest much time and effort developing business networks and prefer to obtain business via people they know and trust. All three directors we interviewed expressed the view that private companies should follow the same governance (best) practices as public companies,

⁵ Most private equity firms buy at least 51 percent of the outstanding shares. In some cases, where they buy less than 50 percent, they still buy a substantial ownership stake (30 percent) that gives them one or more seats on the board and significant influence on corporate decisions.

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 found no case where the board had taken the lead in selecting the auditor. However we were surprised to find that four private companies (out of eleven) had used a RFP to select the auditor (see Table 1).

Directors, private equity firms, and bankers communicate directly (in private) with the auditor. They expect the auditor to be completely candid about any accounting and internal control or governance concerns. Directors were also interested in obtaining the auditors' assessment of the quality and adequacy of management's capabilities and controls. A perception that the auditor is less than forthcoming severely undermines their trust and relationship with the auditor. Directors, private equity firms, and bankers perceived wide variance in the communication capabilities of audit partners across all audit firms. Auditor reputations are personal and users had some clear preferences for some partner(s) over others in each audit firm⁶.

All users wanted an auditor to be an accounting expert and understand the industry. CFOs, directors, private equity firms, bankers, and bonding agencies cared deeply about the reliability of accounting data, wanted an expert to proofread all disclosures, and the fact of an independent audit added to their confidence in the financial statements. All CFOs wanted accounting advice, and sometimes wanted the auditor to do some accounting work for them. All users also cared

⁶ The audit research literature has identified audit firm office size, and dominance in a local market, as being important determinants of audit quality. However, none of our participants mentioned the office; only the firm name, and individual partners.

about the quality of internal control, wanted the auditor to identify deficiencies, and make suggestions for improving all accounting systems and controls. CFO's found the mention of a control-related suggestion in the auditors' management letter to be an effective tool for driving operating and systems changes in their organization. Directors, private equity owners, and sometimes bankers also monitored management to see how responsive they were to auditor suggestions. A CFO who was unresponsive to internal control suggestions was in danger of being fired by the company. Likewise, a CFO who generated too many end-of-year adjustments, or refused to make adjustments suggested by the auditor would be seen as being incompetent and risked getting fired by the company. 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. Ability to provide tax and various types of business advice was clearly a positive factor that would favor hiring a specific auditor. All users wanted auditor involvement in reviewing tax compliance, and most were receptive to auditor involvement and providing tax planning suggestions. 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)

Users were receptive to auditors connecting them to business networks though expectations of such activity 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. There was a general presumption that auditors were independent, and

no concerns were mentioned by participants about actual or appearance issues with respect to auditor independence.

Eight companies in our sample (of eleven) purchased an array of consulting services. Sometimes even the smallest companies had elaborate tax shelters and subsidiaries set up in various tax havens such as Ireland and Cyprus. Clients of Big-4 audit firms preferred to buy services from their audit firm (one-stop shopping), and desired having a single point of contact (relationship partner) who managed all their service needs in the audit firm. Most CFOs wanted the best expert, regardless of location. 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 being involved with competing Big-4 audit firms.

The Request for Proposal [RFP] Process in Private Companies

Fee is the final consideration in hiring an auditor. There was a widespread feeling that there is little or no difference in quality of service across all audit firms. Commoditization of auditing combined with a recession created pressure on audit pricing.⁷ The general view across all respondents was that putting the audit out for proposal (RFP) was an effective device for lowering the audit fee, though some worried that it had only a short term effect and was not worth doing. Auditors we interviewed did not like RFPs and preferred to do business in the traditional way by developing personal relationships with senior managers and/or corporate directors. All three directors in our sample expressed a preference for periodic tendering of the audit as a good governance process. The CFOs in our sample tended to view tendering as a

⁷ 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.

mechanism for lowering audit fees. For the most part, audit firms felt compelled to respond to such RFPs to maintain their relationships with key CFOs and directors in their local market.

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

Table 2 shows that Company 1 had a significant poorly run and poorly performing subsidiary. A decision was made to invest significant amounts of additional capital, improve internal controls and improve financial expertise of management. Despite these changes, the audit firm (Big-4 Firm A) continued to increase its fee, rotated a partner off this client and brought in a younger partner, and had poor staff continuity. The president decided to do an RFP to significantly reduce the audit fee, and send a signal to the auditor that it was not being responsive to the business and its changing environment.

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

the proposed partner, he did not make himself available and let the partner talk to the newly hired controller of the company⁸.

In a field study of public company RFPs, Fiolleau et al. (2013) report that auditors in a RFP usually expect the incumbent to bid the same fee as the preceding year. The incumbent [Big-4 firm A] however knew they would lose this client if they followed that script, and this company was part of a very large business group that was a significant client of the audit firm. As shown in Table 2, the incumbent guessed correctly that its main competitor [Firm B] would bid about 75 percent of last year's fee (given the structural improvements in the company) and so first set a bid at 75 percent of last year's fee, and then offered a special discount to get the fee down to 57 percent of last year's fee. A previous partner and manager, who were liked by management, were assigned to this engagement, and assurances were provided on staff continuity. One Big-4 competitor (Firm C, who had received the least information from the company) offered a bid of 40 percent of last year's fee, but this was deemed to be too low and not a serious bid. Since the president did not like the proposed partner, no bid from this audit firm was likely to have been accepted.

In Company 4, management wanted a Big-4 firm because they wanted to sell equity in the firm. Two of the bidders (Big-4 firms C and D) had personal ties with at least one director, and the CFO was an alumnus of firm C, so the selection was narrowed down to Firms C and D. Even though relationships favored Firm C, the lowest bid came from Firm D. Firm C was given a second chance to revise their bid and urged to "sharpen their pencil" and come up with a lower bid. Firm C did not lower their bid much but provided some "free" consulting hours in their audit

⁸ 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.

fee. Despite the relationship strength, management chose the lowest cost bid, and Big-4 Firm D was appointed as the new auditor. The CFO thought the audit was a commodity and despite his personal preference for Firm C, he could not justify advising the CEO to pay more for an auditor.

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

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

Firm A was appointed as the new auditor even though it was the highest bidder on this RFP. One interesting twist was that Firm A had bundled in some "free" consulting hours in their audit fee⁹. 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, bundles the fees for audit and consulting services into

⁹ The hours can be used anywhere from seeking accounting and audit assistance, tax advice, or more general consulting services.

a single amount labeled audit fee. Officially, the client paid no consulting fee. Management claimed to be extremely pleased with their new auditor (Firm A) and had subsequently sought advice on several major finance related issues from the auditor.

In Company 10, the bank asked for an audit and the management looked for the lowest bid. Again there was no board involvement. The process was straightforward, and the lowest bidder (a national firm) who bid 50 percent 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 3 year quote to keep them from raising the audit fee after the engagement. CFOs believed that one consequence of putting the audit out for tender is a significantly lower audit fee. Management were correct in this belief. Likewise auditors were quite aware of how they and their competitors would present themselves to the company. Previous experimental research suggests that auditors have weak interpersonal expertise in understanding other auditors, and how others view them (Jamal and Tan 2001, Tan and Jamal 2006) though in a field setting auditors seem to have very good inter-personal expertise, and they have quite accurate understanding of what management wants, and how their competitors will respond in that setting. Despite the appearance of going through a public company like process, the pre-existing relationship between management and the audit partner had a major impact on the auditor selection process. The RFP process had one clearly dominant decision maker in all cases and the partner could concentrate on understanding risks, controls, and need for business services. Lack of accounting/audit related expertise differentiation meant a lower fee, pre-existing client relationship, or provision of non-audit services were major determinants of which auditor got hired.

Many elements of this section are consistent with agency theory, though in an interesting twist, there is extensive monitoring of the monitor (auditor) in this private company setting. Agents read the auditors management letter carefully looking for comments about internal controls, governance, errors detected and their resolution, and general business advice and assistance. In private companies, auditors are subject to more detailed scrutiny and have to personally communicate findings to a wider array of agents than in public companies. Some elements are more consistent with institutional theory. There is broad faith in auditor independence, an emphasis on getting along with management and a “fit” with the company, and focus on personal relationships. The eagerness to get business advice allows few limits on the auditor’s involvement in operation and management of the company; we see few concerns about conflicts of interest or knowledge spillovers to competitors. There was absolutely no interest on the part of third parties to have a direct say on auditor appointment. While independence issues (auditor appointment, consulting) are major issues for regulatory debate, these issues attract virtually no concern among our private company audit participants.

[Insert Table 2 here]

How is Audit Quality Assessed?

The overwhelming criterion for assessing audit quality was the quality of the output of the accounting system, namely the quality and reliability of the financial statements. Except for three CFOs who were interested only in buying an audit certificate, other CFOs and users of financial statements cared deeply that an effective audit is performed at a reasonable price, and they thought of the audit as providing significant protection and comfort to them personally as they carried out their duties.

The first opportunity to assess audit quality is in the review of the audit plan. According to audit standards (PCAOB Auditing Standard No. 9, 2010), audit planning judgments (audit hours, risk assessments, staffing, timing) are made by the auditor to bring the risk of audit failure down to an acceptable level. However, in practice these judgments are not made by the auditor alone, they are made in consultation with the CFO and reviewed/approved by the board. CFOs treated the external auditor as if (s)he were a part of the company's internal (or their personal) control system, and it was natural to let the auditor know where (s)he wanted more testing to be done, what staff to assign to the audit, and when necessary, even ask for the partner to be replaced in absence of a "fit" with the CFO. For example, a 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. 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. 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"* a director said. An auditor whose risk assessment did not conform to the CFO and board members views of where the key risks were, and where the major audit effort should be allocated, was deemed to be incompetent¹⁰. For example, a director said:

¹⁰ 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.

“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, Grazioli and Jamal 1993, Johnson, Grazioli, Jamal and Berryman 2001) and an effective fraud detector when all audit planning is done in consultation with management and the board.

A second facet of assessing audit quality came from the 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 the best practice. Any error in a number or disclosure would be embarrassing for the CFO and the directors, and would undermine their faith in the auditor. The auditor is supposed to catch such errors before financial statements are released. Finally, CFOs and directors monitored the number of adjusting journal entries at the year end. Since these agents, as well as bankers, bonding agencies, and private equity funds make decisions based on periodic reports produced by the company, they did not like big surprises at the year end. 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 was the advice provided on improving internal controls, tax and other business processes. The CFO, directors, private equity firms, and sometimes even bankers

read the auditors management report and were keen to know the auditors' views on improving controls, governance, staff capabilities, and general business process improvements. Recommendations on controls had to pass a "practicality" test and be operational, and not just be a recitation of textbook issues that could not actually be implemented. CFOs and directors strive to assess how much of the advice they are getting is really tailored and relevant to them, and how much is just some boilerplate content. They also want their preferences of GAAP to be consistent with those of their auditor (See also Jamal and Tan 2010).

In addition, the auditor is expected to provide business process advice. It was not sufficient to limit recommendations only to accounting and control issues. The auditor had to show a real understanding of the business and provide advice on how to run it better, and make it more profitable. For tax advice, directors preferred the audit firm to be a bit conservative, and not to pitch very aggressive tax schemes.

There were three CFO's who were just buying an audit certificate because someone else wanted it. This would be consistent with an institutional theory view of the audit. The remaining 24 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 actually quite surprising to us. 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 view was incompetent was also surprising. This intense scrutiny is consistent with agency theory, but not institutional theory where legitimacy is maintained in part by avoiding transparency and external scrutiny. Public company shareholders may know little

about what an auditor does or found during an audit, but in a private company setting, the auditor is monitored intensively by a variety of agents.

Use of Accounting Numbers in Decision Models

Earnings management has been discussed extensively in the research literature (or EM – see Burgstahler and Dichev 1997, Dichev, Graham, Harvey and Rajgopal 2013, Healy and Whalen 1999). It is also commonly believed that private companies engage in more EM than publicly traded companies (Ball and Shivakumar 2005, Burgstahler, Hail and Leuz 2006). Implicit in this discussion is that auditors are either biased in favor of management and hence unable to restrain such earnings management (Kadous et al. 2003), or audit technologies and the nature of GAAP make it difficult for auditors to sufficiently restrain earnings management (Nelson et al. 2002). In the public market, there is a presumption that shareholders are being “fooled” by EM, thus creating a demand for regulatory intervention (for an exception see Ball 2009 who is quite skeptical about both the existence of EM and the fooling of market participants). In this section we explore whether users ignore such accounting distortions (which would be consistent with institutional theory), or whether they know and adjust for various accounting distortions as agency theory suggests.

Private Equity Firms (two interviews and one detailed quality of earnings analysis record)

Table 3 shows that both private equity firms described a five part decision making process. The first step was to obtain and review audited financial statements as well as management’s projections of cash flows for the next five years.

Second, the operating assumptions underlying the cash flow projections would be tested as part of the due diligence process. For example, if the target company was in construction, the order book would be examined to support future cash flow projections. If a company had office

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

Third, a "Quality of Earnings Assessment" would be performed. This earnings assessment could be done in-house, or if the deal was going to have substantial bank financing, a corporate finance unit of a Big-4 firm would be hired to do this analysis. The focus of this analysis is to estimate the sustainable cash flows expected from this business available to pay off debt and taxes (earnings before interest, depreciation, tax and amortization – or EBITDA). The sales growth estimates provided by management would be used to calculate estimated EBITDA for the next five years. Then a series of adjustments would be made to calculate a normalized EBITDA. The adjustments would be for tax shields, related party transactions adjusted to fair market value (e.g., royalties, rent, land, buildings, equipment), management compensation might be motivated by tax so it would be adjusted to fair market value, goodwill, R&D, capital structure, and capital expenditures needed. In addition, some working capital items may be written off (e.g., Accounts receivables older than 90 days may be partially or completely written off even though the auditor did not require a write-off). This would then lead to a set of normalized EDITDA values for five

years that would be used to price the company. Fourth, management quality would be assessed. In addition to discussions with management and examining various internal plans and documents, references would be checked; the top five customers would be visited and observed as they interacted with management; customers would be asked about why they do business with this company, how a change in ownership might affect them, and which employees were critical to maintain continuity of business. Generally private equity companies are reluctant to change top operating personnel (want them to stay and have some ownership interest), though they are more willing to make changes in finance and other support operations.

Fifth, the private equity firm would require the company to have a board, and would then take control of the board. This would give them access to the auditor; and they would clean out insiders and appoint outsiders who help connect the company to important constituencies such as key customers, suppliers, or government officials. 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 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 (four interviews, one lending contract, two detailed examples of risk rating model input and outputs)

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. A loan document provided by a bank also expressly reserved the right to re-negotiate or adjust covenants in response to any change in GAAP that affects calculations of covenants.

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 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 purpose and source of financing.

Our bank participants rate the risk of their clients. The bulk of the weight (about 65 percent) of risk rating is on financial performance, an average of 10 percent is on industry conditions (including concentration/diversification of the company’s products and customers), an average of 10 percent is on assessment of management quality (which includes an assessment of internal control, and governance), about 10 percent on capital risk (and items such as guarantees,

collateral), and 5 percent is on idiosyncratic risks that could materially alter the company's performance. Each of these variables is assessed based on a series of questions, some of which require qualitative responses. Governance is assessed based on existence of a board and its powers. Bankers like to see two sub-committees, an audit committee and a corporate planning committee (focusing on strategy and operations with oversight of capital expenditures). They like to see some accounting expertise on the audit committee. Background checks are done on audit committee members, so if a director of a public company has been involved in a scandal, then their impaired reputation in the public market will hurt them in the private market as well.

The financial performance variable is assessed based on profitability (sales growth, gross margins), liquidity (current ratio), the amount of investment, leverage (tangible net worth, total liabilities/EBITDA), capital expenditures, and cash flows (EBITDA). Prior to calculating inputs for their models, Banks have a central specialist data entry department who make a series of adjustments to accounting data (for leases, related party transactions, taxes, and they may write-off receivables or inventory older than 60 days even if the auditor allowed the company to carry them as assets on the audited financial statements). Ratios are calculated based on these adjusted accounting numbers. Having a specialist data entry department develops expertise and consistency in data entry. It also reduces the possibility of loan officers entering biased numbers into the bank risk models to favor the companies in their portfolios. There were frequent mentions of EBITDA as a key measure suggesting that certain accounting items like depreciation, amortization, interest, and taxes were routinely adjusted for before financial numbers were used in decision making.

Bankers mentioned the importance of having clarity in the notes to the financial statements, and the need for consistency in application of GAAP. They were keen to know if there had been

any change in the way a client company implemented GAAP. Changes in assumptions, discount rates and other estimates were of interest to them. If the loan amount was large, bankers would ask to see the auditor's management report, and might even ask for an annual meeting with the audit partner or manager.

Benchmarking and accounting consistency were the key variables. Bankers expressed some concern that IFRS was "too loose" and allowed too much judgment. None of our Bank participants had any weight in their model for quality of accounting, quality of auditor, or any direct accounting variables. Bankers were not comfortable rating the quality of accounting of any company, and thought that speaking about accounting quality was too difficult given how "loose" IFRS standards are.

Bonding Agencies (two interviews and one detailed data input worksheet)

The bonding agencies [surety companies] in our study were subsidiaries of insurance companies who primarily provided bonding coverage to construction companies though they had other clients as well. The main risk to these agencies is that a bank refuses to renew a loan for a construction company, and the construction company cannot complete a bonded contract.

Table 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, R&D, and related party assets. The schedule also had a section with a heading of "adjusting current assets" where accounts receivables, inventories, marketable securities, and other receivables on the financial statements could either be deleted or a portion could be written off. Likewise,

related party transactions could be adjusted in whole or in part. There were explicit headings for tax shields and management bonuses to be adjusted, though the bonding agencies seemed to have considerably less financial expertise than the bankers, and it was not clear how many adjustments were actually made. Again there was no explicit assessment made of accounting or auditor quality of any client.

Directors (three interviews, no documents)

All three directors we interviewed were distinguished Chartered Accountants¹¹ who have served as CEO's of various companies, and currently serve on boards of both publicly traded and private companies. They all would easily qualify as being "financial experts" for SOX governance purposes.

The directors claimed that they tended to 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 (and especially monitor receivables and inventory), and capital requirements/leverage of the business. They seem to be using a return on investment type metric, though returns were thought of in terms of operating cash flows.

Table 3 shows that all three directors commented that accounting numbers and disclosures were becoming more complicated over time, were harder to understand, and were obscuring what was really going on in the company. Over time, accounting was becoming less useful to them in understanding and carrying out their role as directors.

¹¹ Canadian accountants have to work in public accounting and have 3 years of experience as auditors prior to becoming Chartered Accountants, so all three directors had started their careers as auditors in Big 4 firms. The Canadian accounting profession has changed in 2015, and these individuals would now be CPAs.

All directors asked the CFO to recast the financial statements into a form they could use and focus more on understanding operating cash flows and the key metrics that management uses to operate the company. They tended to ignore accounting accruals as much as possible, though they all acknowledged that they would have to pay much more attention to accounting numbers and disclosures when they serve on boards of publicly traded companies. Public company accounting gets more regulatory scrutiny, and accounting issues place more risk on the directors.

[Insert Table 3 here]

The complaints about GAAP by this elite group of directors (and similar complaints by bankers, and the dominant focus on EBITDA in various versions by private equity) mirror the inconvenient truths about GAAP raised by Palmrose (2009) who claims that GAAP is broken, not based on general acceptance or understanding, that accounting is evolving in a manner where increasing complexity of GAAP makes it harder for users to understand the company, and that companies cannot participate meaningfully in standard setting activity (see also Jamal and Sunder 2014). Fair value estimates in GAAP reduce the “hardness” of accounting numbers and thus willingness of users to rely on accounting for contracting purposes. GAAP also does not capture intangible assets well (Srivastava 2014), thus causing private equity firms to rely on other experts to verify intellectual property and other such assets. As GAAP becomes less relevant and less useful to users, the value of accounting numbers declines, and likewise the value of the audit also declines.

It may well be the case that private companies have more EM, driven by tax or other considerations than impressing shareholders. However, users of private company financial statements spend considerable time, and bring sophisticated knowledge of accounting, to

standardize information. We saw no evidence of functional fixation, and very little automatic reliance on audited financial statements. Users are quite skeptical of audited information and do extensive analysis and adjustment (normalization) before using such data. Banks require monthly, quarterly and annual financial reports, thus there is detailed monitoring of private company accounting. Banks also have specialists who extract accounting information and normalize it. Private equity firms also do extremely detailed analysis and re-casting of financial statements using the highest level of accounting expertise available (usually done by a Big 4 audit firm). Our directors were also “financial experts” with considerable business experience and unlikely to be fooled by any accounting manipulations. Bonding agencies appear to have much less accounting expertise, but also relied on only a small subset of liquidity information. So while there may be some EM done by preparers, it is unlikely that users were systematically “fooled” by accounting manipulations. These results are consistent with agency theory whereby users are diligent and carefully monitor actions of companies. Financial and non-financial information from different sources is accumulated over time to evaluate company performance. These results are not consistent with institutional theory notion that the preparers are able to engage in material amounts of EM because they can shield themselves from external scrutiny.

5. Summary and Implications for Regulation of Auditing

This study investigates why private companies hire auditors, and how they go about doing so. We also investigate how various agents involved in private company audit (preparers, auditors, directors and users) determine what they want from the auditor, and how they define audit quality. A field study was conducted to gather interview data as well as primary documents (lending contracts, quality of earnings analysis, data input forms, and RFPs for auditor services) from CFOs, auditors, bankers, private equity firms, bonding agencies, and corporate directors.

Our results indicate that demand for private audits comes from a much wider set of agents than those studied in the accounting literature. Desire to access debt and/or equity capital creates demand for audit, though customers, suppliers, internal governance demands, bonding agencies and other regulators also seek audited financial statements for private companies. Management however, is not willing to share audited financial information equally with all users, and certainly does not provide information to the general public. This suggests that the accounting literature may need to examine more fully the propriety of decisions made by countries such as the US and Canada to drop their requirement for private companies to be audited in the 1990's, and also whether the audited financial statements should be made publicly available as is the case in some European countries.

In private companies, management selects the auditor, and companies seeking to access equity markets prefer Big-4 auditors, whereas companies seeking access to debt capital are indifferent as to audit firm size. Management and all user groups want the auditor to be a business advisor and provide tax, internal control, and business services that help the company operate more efficiently and become more profitable. Regulators have sought to counteract these incentives by getting the audit committee to hire the auditor for public companies (now required by SOX), press companies to hire from a broader set of firms beyond the Big-4, and restrict the set of consulting services clients can buy from their auditors. There is no evidence that regulators have succeeded in achieving these three objectives (see Dhaliwal et al. 2014). There are substantial doubts about the desirability of these objectives, and especially whether restricting consulting services serves shareholders' interests (Kinney et al. 2004). We find that when private equity investors and banks have an opportunity to help choose the auditor, they refuse to do so and rely on management to make the choice. Yet so much audit literature and regulatory debate is focused

on auditor selection. Are there more subtle information, possibly signalling, issues involved here, or are the regulators making too much of auditor selection and provision of non-audit services (see also Jamal and Sunder 2011 for evidence of how participants in a private baseball card grading market show little concern about independence of graders)?

More recently, regulators have sought to force audit firm rotation and/or require the audit committee to put the audit out for tender (i.e., RFP). This has been promoted as a mechanism for enhancing independence of the auditor. Field observations suggest that, instead of promoting independence, audit firm rotation will only serve to drive down the audit fees as undifferentiated audit firms vie for customers by reducing their fees, offering consulting services or building client relationships. Increasing the frequency of tendering the audit seems just as likely to reduce independence and audit quality, as enhance it.

In private markets, CFOs and corporate directors treat external auditors as part of their internal control system. Focus and scope of the audit plan, including audit hours, risk assessments, staffing, timing and location of procedures, are subject to discussions with the CFO and have to meet the expectations of CFOs and corporate directors. These audits are oriented to detecting error, not fraud. Consequently, there is little randomness/unpredictability in the auditors' work (Johnson, Grazioli and Jamal 1993). Surprisingly, regulators have carried this feature of private auditing over to the public market. In public companies, external auditors are required to submit their detailed audit plans for review and approval of the audit committee (PCAOB Auditing Standard No. 16 2012). There is virtually no scope for a public company auditor to surprise management and disrupt a fraud. It is therefore not surprising that external auditors are seldom the agent who detects a fraud (Dyck, Morse, and Zingales 2010). This does

raise a question as to why regulators want to preserve this feature of private audit markets even as they claim an interest in improving the effectiveness of the external auditor in detecting fraud.

Users of audited financial statements in private markets have access to extensive private information about the quality of internal controls, governance processes of companies, capabilities of management and the audit partner/managers. Users also hire additional experts to verify the key numbers they intend to rely on (i.e., are not necessarily functionally fixated), and make adjustments for known deficiencies of accounting (e.g., add lease obligations to the companies' debt) and audited financial statements (e.g., adjust for biases due to tax considerations, related party transactions, and non-cash items subject to significant managerial opportunity for manipulation). While it is possible that preparers might still have some opportunity for EM, it is not easy to materially "fool" users of audited accounting numbers. The more troubling finding is that even expert users find GAAP financial statements to be more complex and less useful over time, and seek to avoid using accounting measures by focusing on simpler cash flow measures. In public markets, investors have less access to information about the quality of internal controls (just a pass/fail report), internal governance processes, and the quality of accounting estimates made by management.

Definitions of audit quality in the research literature usually focus on independence and expertise (DeAngelo 1981a,b), though the PCAOB reviews also cover internal processes of the audit firm (culture and tone at the top). Our field study suggests that the PCAOB (2015) is correct to broaden the definition of audit quality to include outputs of the accounting system (quality of financial statements, and identification of errors, fraud, and internal control deficiencies) as audit quality indicators. Private agents, who demand audits, value independence which they define as being candid in private meetings. They also value industry expertise, error

identification, and suggestions for improvement in internal controls, tax and other operating procedures. However, they neither demand nor expect auditors to detect fraud.

Auditor independence and expertise are assessed based on audit processes and outputs. An audit plan (consisting of inputs and processes) that doesn't accord with the expectations of management and/or the Board is deemed incompetent. Likewise an auditor who doesn't provide tax advice and improvements in control/governance is deemed to be of lower quality. If too many financial statement adjustments are made, management will be deemed to be incompetent. If these adjustments are made at year end, the auditor may also be deemed to be incompetent. Errors in the financial statements found later (regardless of whether they trigger a restatement) also discredit management, the auditor and the board. The outputs of the accounting system thus play a pivotal role in defining audit quality. Extensive monitoring of the auditor by other agents results in audit quality being assessed based on auditor inputs, risk assessment processes, and outcomes. Relevant outcomes are not just about the reliability of financial statements, but also encompass controls, governance, tax and general business advice.

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Appendix 1
Sources of Data

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

Appendix 2

Question Script for Discussion with Non-Auditor Participants

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

TABLE 1*Background of Companies in Private Audit Study***Panel A: Companies Audited by Big 4 Audit Firm**

Company	Dominant User of Audit	Has Board of Directors	Chose Auditor Using RFP	Sales (\$)	Dominant 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	Dominant User of Audit	Has Board of Directors	Chose Auditor Using RFP	Sales (\$)	Dominant 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

TABLE 2*Summary of Request For Proposal [RFP] Processes for Selecting a Private Company Auditor*

	Company 1	Company 4	Company 6	Company 10
Incumbent Auditor	Big 4 Firm A	Non-Big 4 Firm	Big 4 Firm D	Big 4 Firm D
New Auditor	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
Why do an RFP	<ul style="list-style-type: none"> Want a substantially lower fee (had made major injection of capital, improved internal control, and hired more a capable Controller) Want a partner with more stature 	<ul style="list-style-type: none"> Want Big 4 auditor to prepare company for sale to private equity firm Get best auditor 	<ul style="list-style-type: none"> Lack of fit with current auditor (D) <ul style="list-style-type: none"> They don't think about the business the way management does Had last minute adjustment to financial statements (surprise) Management was being solicited by Big 4 Firm A's office managing partner Get best auditor 	<ul style="list-style-type: none"> Want low fee (concluded that audit doesn't provide much value)
Who is invited to Bid on RFP	<ul style="list-style-type: none"> All Big 4 Firms [A,B,C,D] One non-Big 4 [local firm] 	<ul style="list-style-type: none"> 3 Big 4 Firms [A,C,D] Didn't like Big 4 Firm B – thought they would bid low and then extra-bill 	<ul style="list-style-type: none"> All Big 4 Firms [A,B,C,D] 	<ul style="list-style-type: none"> 2 Big 4 Firms [C,D] 3 National firms
Firms who Bid	<ul style="list-style-type: none"> 3 Big 4 Firms [A,B,C] bid – all had ties with the President Big 4 Firm D did not bid because they thought this RFP was just to reduce the fee and would go to the incumbent Local Firm did not bid because they thought they lacked the industry expertise needed to audit this client 	<ul style="list-style-type: none"> 3 Big 4 Firms [A,C,D] A had no ties to Management or the Board C had ties to a director and the CFO was an alumni of Big 4 Firm C D had ties with a director 	<ul style="list-style-type: none"> All Big 4 Firms [A,B,C,D] Firm A courted the CEO Firms B,C,D courted directors 	<ul style="list-style-type: none"> 2 Big 4 Firms [C, D] 3 National Firms One National Firm did a lot of consulting work for the company but did not get chosen to be auditor
Fees	<ul style="list-style-type: none"> Incumbent Big 4 Firm A Bid 57% of last year's audit fee in a 2 step process where they first bid 75% of last year, and then gave a special discount bringing the fee down to 57% Big 4 Firm B bid 76% of last year's fee Big 4 Firm C bid 40% of last year's fee 	<ul style="list-style-type: none"> Big 4 Firm A was the highest bidder and deemed not to be too enthusiastic Narrowed down choice to C and D C bid was 62.5% higher than D's bid 	<ul style="list-style-type: none"> Big 4 Firm A was highest bidder but had bundled "free consulting" hours into the audit fee (no other firm had bundled consulting with audit) 	<ul style="list-style-type: none"> One National Firm bid 50% of last year's audit fee so they were the lowest bidder

(Continued)

TABLE 2 – Continued

	Company 1	Company 4	Company 6	Company 10
Decision made by	<ul style="list-style-type: none"> • President • Board not involved 	<ul style="list-style-type: none"> • 3 members of management (CEO, CFO, Controller) • Board Chair • CEO is the dominant decision maker 	<ul style="list-style-type: none"> • CEO (dominant decision-maker), CFO, and Controller • Justification memo for auditor switch provided to the Board, who in turn voted to accept the recommendation 	<ul style="list-style-type: none"> • CFO • No Board Involvement
Information Sharing	<ul style="list-style-type: none"> • 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. • President didn't like the partner proposed by Big 4 Firm C so didn't meet with him – partner only had access to the Controller 	<ul style="list-style-type: none"> • 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 • Firm C made very little price revision but bundled in some free consulting hours in the audit fee 	<ul style="list-style-type: none"> • Systematic – all bidders were given the same information 	<ul style="list-style-type: none"> • Systemic – all bidders were given the same information and told the fee was the main consideration
Methodology	<ul style="list-style-type: none"> • Want comfort that the auditor understands the business (the same way as they do) so very interested in audit plan, hours and who does the work • Want high level review of disclosure • 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 	<ul style="list-style-type: none"> • Want someone thinking about our business • Want audit program to focus on the risks that management cares about 	<ul style="list-style-type: none"> • Very high emphasis on having auditor understand business as we understand it (=fit) • Liked the “free” consulting hours in the audit fee • Really liked Firm A because they had courted the CEO, thought of the business (audit plan) the way management did, and proposed 4 meetings per year to avoid having any last minute surprises 	<ul style="list-style-type: none"> • Don't care what the auditor does – buying a certificate for the bank • Don't believe the auditor has any great insight into the company's operations based on the very limited time they spend on the audit
What made winning auditors stand out?	<ul style="list-style-type: none"> • No expertise difference (audit is a commodity) • Responsiveness – the incumbent reinstated a partner and manager liked by management • Fee discount for 3 years – though not the lowest bidder 	<ul style="list-style-type: none"> • Low fee • Audit is a commodity so even though CFO was Alumni of Big 4 Firm C (and really liked C), could not justify paying higher price 	<ul style="list-style-type: none"> • Firm A solicited CEO prior to RFP. Had relationship with the dominant decision maker • Auditor A brought National CEO to meet management – made them feel special • Think of the business the way management does, and series of scheduled meetings with management and the board • Not fee – the highest bidder won (though not clear how to apportion fees between audit and consulting). 	<ul style="list-style-type: none"> • Lowest fee

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"> • Sophisticated calculation of various versions of EBITDA, such as: <ul style="list-style-type: none"> - EBITDA - Forward EBITDA - Maintainable EBITDA - Normalized EBITDA - Trailing Twelve Months EBITDA (TTM) 	EBITDA	EBITDA	Operating Cash Flow
Assess management quality	<ul style="list-style-type: none"> • Very detailed assessment • Prefer to keep senior operating managers and have them retain a material shareholding in the company 	<ul style="list-style-type: none"> • Detailed assessment of education credentials and experience of managers • Depth of management • Succession plan 	<ul style="list-style-type: none"> • Detailed assessment • Has ongoing relationship with management 	<ul style="list-style-type: none"> • Very detailed assessment • Has personal knowledge of how management runs the company
Governance and internal control	<ul style="list-style-type: none"> • Require company to have a Board • Control Board and appoint the Board Chair • Professionalize the Board and bring in new directors who have connections to important customers or suppliers • Have access to the auditor's management letter on internal control 	<ul style="list-style-type: none"> • Look for presence of Board as it improves the firm's governance rating • Perform public search on reputation of directors, especially those on audit committee • If the loan is very large, may request a meeting with auditor and/or copy of auditor's management letter on internal control 	<ul style="list-style-type: none"> • No Assessment 	<ul style="list-style-type: none"> • Prefer a mix of insiders and outsiders on the Board • Have access to the auditor's management letter on internal control

(Continued)

TABLE 3 – Continued

	Private Equity	Bankers	Bonding Agencies	Corporate Directors
Adjustments to Financial Statements				
1. Partial write-off of audited values of current assets (A/R, Inventory)	Yes	Yes	Review	No
2. Adjust for tax shields	Yes	Review – not clear if they have expertise to make such adjustments	Review – not clear if they have expertise to make such adjustments	No
3. Related party transactions	Adjust to fair market value	Review	Review	Review
4. Adjust management's compensation to fair market value	Yes	No adjustment made, but a limit on compensation is stipulated in a covenant	No, but managerial pay is deducted in financial calculations	No
5. Adjust capital structure	Yes, adjust to optimal level	Add unrecorded debt (e.g. Leases)	No	No
6. R&D	Appraise value	<ul style="list-style-type: none"> • Ignore – it is not liquid • Deduct from assets when inputting data into model 	<ul style="list-style-type: none"> • Ignore – it is not liquid • Deduct from assets when inputting data into model 	Approve/monitor investments
7. Proposed capital expenditures	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