Audit Firm Selection: Think Like an Institutional Investor

By Adam J. Epstein

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There are a handful of firms that perform the vast majority of audit work for the Fortune 1000. For the 76 percent of U.S. public companies that have market capitalizations of less than $500 million, there are literally *hundreds* of audit firms from which to choose. With so many choices, how can the audit committees of small public companies efficiently weigh their options? One way to simplify the process is to think like an institutional investor.

Generally speaking, the smaller the public company, the higher the percentage of shares owned by retail investors (i.e., non-professional investors). For example, companies with market capitalizations below $250 million are often 70 percent to 90 percent owned by retail investors, whereas multibillion-dollar public companies are often 85 percent owned by institutional investors.

While retail investors typically don't spend a lot of time factoring a small public company's audit firm into their investment decisions, institutional investors do—and then some. Institutional investors invest predominantly in financial performance, and the reporting of financial performance is thorough, reliable, and accurate—or it isn't. Therefore, and not surprisingly, most institutional investors have fairly refined opinions about which audit firms are satisfactory and which aren't.

And since those investors are ultimately the ones who write the checks—they don't call it the "buy-side" for nothing—small public companies that are otherwise well suited to begin evolving their shareholder base from retail investors to institutional investors have little choice but to pay attention to investor preferences.

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However, this creates an interesting conundrum for many aspiring small-cap companies. Large public companies typically choose from a handful of audit firms that are all affordable, acceptable to institutional investors, and highly solicitous of their business. Small public companies choose from a seemingly endless list of audit firms, but, depending upon the size and health of the company, many of the firms that institutional investors are likely to favor are unaffordable and might not want to audit riskier, smaller companies.

Therefore, the selection process for many small companies' audit committees ends up being a Venn diagram with three principal inputs: affordability, the audit firm's willingness to audit, and the firm's reputation.

Two of the three inputs are easily gauged—an audit firm's affordability and its willingness to audit the company. Reputation, however, is where many small public company audit committees struggle to find the appropriate barometer and also to provide the proper weighting.

While an audit firm's reputation means different things to different constituents, the austere reality is that only one group's opinion ultimately matters—institutional investors. The boards of aspiring small-cap companies can't afford to underestimate an ominous capital markets truism: the choice of audit firms can prove to be an impediment to widespread consideration by institutional investors.

Developing a Candidate Pool

Although it would be nice if institutional investors collectively

published a list of all the audit firms that were on their “approved” list, they don’t. But what small public company audit committees can do is to apply the same criteria for choosing an audit firm that institutional investors do in order to develop a list of candidate firms. The best way for such companies to choose from an institutional investor–approved pool of audit firm candidates is to think like an institutional investor.

There are four principal criteria that institutional investors weigh when evaluating audit firms:

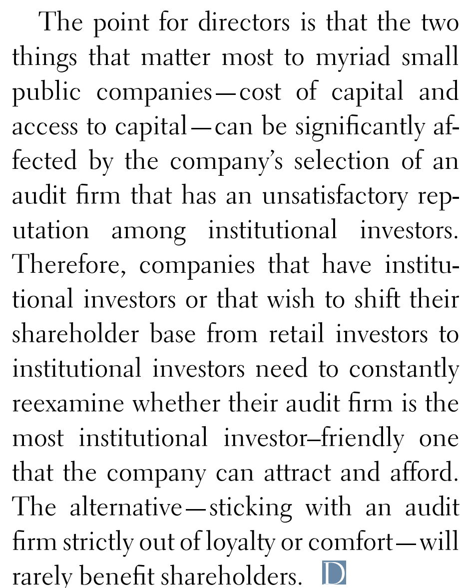
- PCAOB/peer audits. One of the critical ways that audit firms develop good reputations with institutional investors is by having exceptional results from audits of their firm conducted by the Public Company Accounting Oversight Board and through peer review entities like the American Institute of Certified Public Accountants.
- Regulators and media. When audit firms do their jobs well, they are typically not mentioned in the media or singled out by state and federal regulators. Therefore, the extent of the firm’s public profile is often inversely proportional to the regard in which the firm is held by institutional investors.
- Industry expertise. Like all professional service providers, audit firms often distinguish themselves by demonstrating particular expertise in auditing certain industries.
- Consensus. Institutional investors constantly compare notes with one another and pull together what they’ve witnessed, read, and heard.

The key point here for small public company audit committees is that by striving to identify a pool of audit firm candidates utilizing the same criteria as those applied by institutional investors, they can be reasonably confident that the chosen firm will be acceptable to institutional investors.

Poor Choices Can Prove Penal

Because there are so many audit firms of such disparate quality that serve the micro- and small-cap markets, the choice of one firm over another can have material capital-markets implications.

Think of it from the perspective of an institutional investor. Gauging the strengths, weaknesses, opportunities, and threats to any small public company is perilous enough. To then layer on concerns about the integrity of audited financial statements not only creates a fundamental issue of valuation but an equally important matter of perception. In other words, even if a particular company’s financial statements are perfectly accurate, a negative consensus about its audit firm among institutional investors is likely to create a negative feeling about the company’s stock. Consequently, wherever there are concerns about the quality and reputation of the audit firm, institutional investors will either invest less or not at all.



The point for directors is that the two things that matter most to myriad small public companies—cost of capital and access to capital—can be significantly affected by the company’s selection of an audit firm that has an unsatisfactory reputation among institutional investors. Therefore, companies that have institutional investors or that wish to shift their shareholder base from retail investors to institutional investors need to constantly reexamine whether their audit firm is the most institutional investor–friendly one that the company can attract and afford. The alternative—sticking with an audit firm strictly out of loyalty or comfort—will rarely benefit shareholders. D

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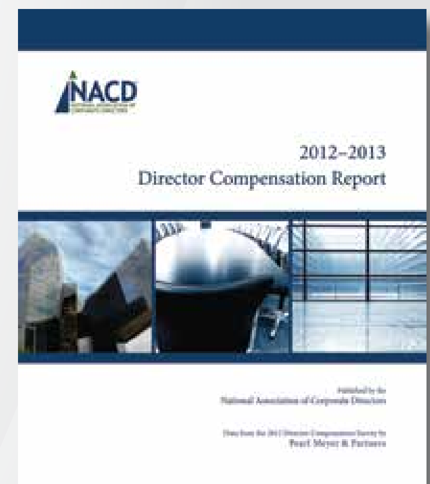

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