



THE IMPACT OF AUDIT QUALITY ON THE FINANCIAL STABILITY OF PRIVATE EQUITY FUNDS

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Abstract

The article systematizes the literature on audit quality and external monitoring mechanisms in PE, identifies the channels through which audit influences a fund's financial stability (reducing information risk, disciplining assessments, increasing the credibility of reporting, reducing the cost of financing, and reducing the likelihood of conflicts with investors), and proposes a conceptual model and a set of testable hypotheses for empirical research. Particular attention is paid to the role of auditor selection (Big 4 vs. non-Big 4), industry expertise, independence and audit procedures in the fair value environment and limited transparency of private markets.

Keywords: Audit quality, private equity, financial stability, NAV, fair value, external monitoring, Big 4, valuation risk, information asymmetry, debt financing.

Introduction

The scientific novelty of this article lies in its substantiation of the role of audit quality as a factor in the financial stability of private equity funds at the fund level, rather than at the portfolio company level. The paper proposes a conceptual model linking audit quality to the stability of PE funds through the accuracy of fair value estimates and NAV stability, and formulates testable hypotheses taking into account the specific nature of illiquid assets and high valuation uncertainty.

In today's evolving global financial market environment, audit quality is a key factor influencing the stability of the financial system and the effectiveness of economic decision-making. The primary function of an audit is to provide users



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of financial statements with confidence that the statements reflect a true and objective picture of the organization's financial position, which forms the foundation for assessing its financial stability and investment attractiveness. A high-quality audit reduces information risk, increases the transparency of reporting, and strengthens investor and creditor confidence in financial information, which is directly related to the financial stability of the entities being audited (for example, IFAC describes an audit as a process that enhances investor and other stakeholder confidence in financial statements) [1].

In academic literature, audit quality is viewed as a set of characteristics and mechanisms that ensure a high probability of detecting material misstatements and promptly communicating such misstatements to stakeholders. From an institutional theory perspective, an effective audit institution allows "outsiders" to assess the state of affairs within an organization at a level comparable to that of insiders, which increases the transparency of corporate governance and reduces information asymmetries between managers and investors [2].

The role of audit is of particular importance in the context of private investment funds (private equity (PE), where the main problems are illiquid assets, model-based valuation of the investment portfolio, and significant information asymmetry between GPs (fund managers) and LPs (limited partner investors). In such circumstances, it is the external confirmation by the auditor of the correctness of accounting estimates (fair value) and NAV estimation procedures (net asset value) is becoming a key element of investor and creditor confidence in the fund's financial statements. Specialized studies on the quality of PE fund reporting have shown that the involvement of an auditor and third-party valuation specialists is associated with changes in reporting quality (NAV accuracy and bias) and that such effects vary depending on the type of fund (buyout vs venture capital) and the nature of external monitors (auditors, administrators, valuation specialists) [3].

The literature also examines the impact of audit quality on key financial and economic indicators of organizations, including the cost of capital and financial soundness risk. For example, a number of empirical studies find that higher audit quality is associated with a lower cost of capital and reduced risk of insolvency, which indirectly indicates a link between audit quality and financial soundness.



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Similar studies in the context of emerging markets confirm the link between audit quality, accruals quality, and financial soundness . quality) and the cost of equity capital of organizations [4].

Thus, examining audit quality as a factor influencing the financial stability of private investment funds represents an important research and practical challenge. This article analyzes this impact through the lens of NAV assessment, the effectiveness of external monitoring, and the informational role of audit in interactions between GPs, LPs, and financial intermediaries.

Private investment funds (Private Equity (PE) funds have a number of institutional and financial characteristics that fundamentally distinguish them from public companies and traditional investment funds and directly affect the interpretation of their financial stability. Firstly, the assets of PE funds are primarily represented by illiquid stakes in non-public companies, the valuation of which is carried out on the basis of fair value models (fair value) using professional judgment and assumptions. As emphasized in the International Valuation Guidelines (IPEV) , such valuations are inevitably associated with a high degree of uncertainty and subjectivity, which increases the information risk for investors and creditors [5].

Secondly, the key aggregate indicator of the financial condition of a PE fund is the net asset value (NAV), which is used to calculate profitability, determine the remuneration of managers (carried interest), and also as a basic guideline when attracting debt financing at the fund level (fund finance), NAV - based Research indicates that the accuracy and stability of NAV are critical to a fund's financial stability, as inflated or smoothed estimates can lead to mispricing of risk, covenant violations , and sharp adjustments during stress periods [6].

Third, the structure of the relationship between general partners (GPs) and limited partners (LPs) is characterized by a pronounced agency problem and information asymmetry. Fund managers have significantly more complete information about the performance of portfolio companies and the valuation process, whereas investors are forced to rely on financial statements and external monitoring mechanisms. Academic literature emphasizes that in such an environment, the quality of financial reporting and the role of external audit institutions, including



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auditors and fund administrators, become important factors in protecting investor interests and maintaining fund stability [3].

Finally, the financial stability of PE funds is increasingly being assessed not only through the prism of profitability, but also through the fund's ability to meet its obligations to investors and creditors during various phases of the economic cycle. Empirical studies show that during periods of market downturns, it is the quality of reporting and the transparency of valuations that determine the degree of trust in a fund and its ability to maintain access to financing and investment capital [7]. In this context, the specific nature of PE reinforces the importance of audit as a tool for enhancing confidence in NAV and mitigating risks threatening the fund's financial stability.

In theoretical and empirical literature, audit quality is considered an important element of the external monitoring system, reducing agency conflicts and information asymmetries. For private investment funds (Private Equity (PE) these mechanisms acquire particular significance due to the illiquidity of assets, the model nature of valuations and limited public information.

1. The first mechanism is the reduction of information asymmetry and agency conflicts. From the perspective of agency theory, audit acts as a control tool that limits the opportunistic behavior of managers (GP) in relation to investors (LP). High audit quality increases the reliability of financial statements and NAV estimates, thereby reducing the risk of manipulation of profitability and remuneration indicators (carried interest). Classic and subsequent studies emphasize that auditors with a high reputation have stronger incentives to be independent and detect misstatements [8].

2. The second mechanism is disciplining fair value estimates (valuation discipline). For PE funds, the key source of risk is the valuation of Level 3 assets under IFRS / US GAAP . External auditing increases requirements for the validity of assumptions, the consistency of methodologies, and the completeness of disclosures. Empirical studies show that the presence of strong external monitors, including auditors, is associated with less bias and greater accuracy in PE fund reporting, and industry valuation standards (IPEV) emphasize the critical role of independent verification in ensuring confidence in fair value. value [9].



3. The third mechanism is the impact on the cost and availability of financing. The financial stability of PE funds largely depends on access to borrowed capital (fund finance), NAV - based Higher audit quality reduces information risk for lenders, which may result in more favorable financing terms and a lower likelihood of covenant violations.

4. The fourth mechanism is early identification of sustainability risks and going Concern . The development of international auditing standards has increased attention to going concern assessments. The updated ISA 570 standard emphasizes the auditor's responsibility for assessing material uncertainties, which increases the likelihood of early identification of liquidity and fund stability risks in stressful conditions. For PE companies , this is especially relevant during periods of market downturns, when the accuracy of NAV and the ability to service liabilities become critical.

Table 1 - Theoretical mechanisms of the influence of audit quality on the financial stability of PE funds

Mechanism	Theoretical basis	Channel of influence	Expected effect on sustainability
Reducing agency conflicts	Agency theory	Improving the reliability of reporting, limiting GP opportunism	Increased LP trust, reduced reputational risks
Disciplining assessments	Information asymmetry theory	Fair control value and NAV	Lower volatility and NAV revisions
Decrease in the cost of capital	Signal theory	Quality signal for lenders	The best conditions for the fund finance , lower covenant risk
Early identification of risks	Stability theory / going concern	Business continuity assessment	Reducing the likelihood of financial stress

The study is based on the concept of audit quality as an element of external monitoring that reduces information asymmetries and agency conflicts between PE fund managers (GPs), investors (LPs), and creditors. Conceptually, audit



quality influences the financial stability of PE funds indirectly, through improved financial reporting and fair value estimates, and directly, through its signaling effect on external stakeholders.

The proposed model is based on agency theory and information asymmetry theory and can be represented as follows:

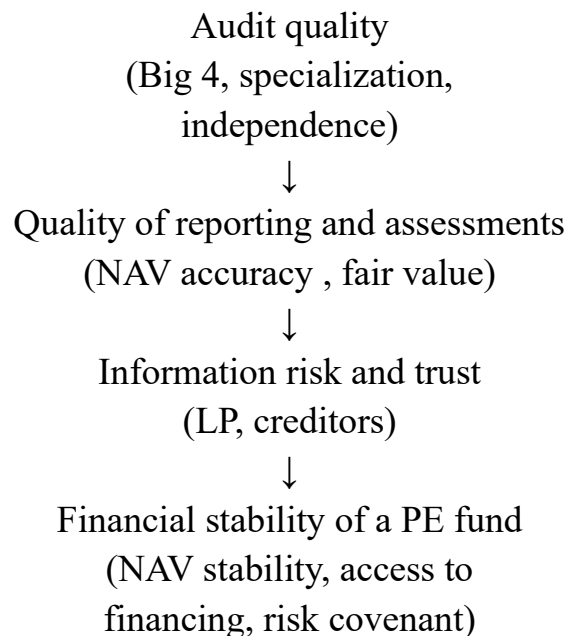


Figure 1. Conceptual model of the impact of audit quality on the financial stability of private equity funds

Audit quality (AQ) is considered as an exogenous characteristic, while the financial stability of the fund (Financial Stability (FS)) as the resulting variable. The intermediate link is the quality of reporting and assessments (Reporting and Valuation Quality), which is consistent with the findings of the empirical literature on PE funds and non-public companies [8].

Formally, the basic dependence can be represented as a simplified equation:

$$FS_i = \alpha + \beta_1 AQ_i + \beta_2 Controls_i + \varepsilon_i,$$

где FS_i — показатели финансовой устойчивости PE-фонда i (волатильность NAV, пересмотры оценок, условия заёмного финансирования), AQ_i — прокси качества аудита, $Controls_i$ — набор контрольных переменных (размер фонда, стратегия, возраст, доля Level 3 активов).

Formula 1. Basic regression model of the impact of audit quality on the financial stability of PE funds



Research hypotheses:

H1. Audit quality and NAV stability. PE funds that use higher-quality auditors (e.g., Big 4 or specialized auditors) demonstrate higher NAV stability and accuracy. Rationale: Literature shows that strong external monitors reduce bias and valuation smoothing [6].

H2. Audit quality and financial risk. Higher audit quality is associated with lower information risk and, consequently, better debt financing terms and a lower likelihood of covenant violations . Rationale: Research on private and non-public companies reveals a relationship between audit quality and the cost of debt [8].

H3. The role of valuation complexity (moderating effect). The positive impact of audit quality on the financial stability of PE funds increases with a higher share of assets valued at Level 3 and with greater complexity of valuation models. Rationale: under conditions of high uncertainty, the value of independent and high-quality verification increases [9].

Taken together, the proposed conceptual model and hypotheses allow us to empirically test whether audit in the PE industry performs not only a formal function of confirming financial statements, but also a broader role as a mechanism for ensuring the financial stability of funds.

The obtained theoretical and empirically substantiated results have practical significance for key participants in the private industry. equity .

Firstly, for management companies (GPs), audit quality should be viewed not only as a mandatory reporting requirement but also as a tool for enhancing the fund's financial stability. Selecting a reputable auditor with industry expertise enhances confidence in the NAV, reduces the risk of significant valuation revisions, and, as a result, improves the conditions for raising debt financing and interacting with investors.

Secondly, for institutional investors (LPs), audit characteristics can serve as an important indicator of the quality of external monitoring and the level of information risk of a fund. Taking audit quality into account when selecting and monitoring PE funds allows for a more accurate assessment of the risks associated with the valuation of illiquid assets and financial stability in stressful market conditions.



Thirdly, for lenders and fund providers The study's findings confirm the usefulness of using audit parameters and NAV stability as risk management elements when structuring transactions and establishing covenants. A higher level of audit control reduces the likelihood of unexpected deterioration in a fund's financial performance.

Finally, for regulators and professional organizations, the findings highlight the importance of developing auditing and fair value measurement standards in the private equity sector. Strengthening requirements for transparency and audit quality can help reduce systemic risks and improve the sustainability of the private sector. equity in general.

Therefore, audit quality is an important factor in the financial stability of private Equity funds by reducing information and valuation risks, disciplining NAV, and improving financing conditions. Despite a growing literature, empirical research specifically at the PE fund level (as opposed to portfolio company level) remains relatively limited, opening the door for research linking auditor characteristics, asset structure (Level 3), valuation practices (IPEV), and resilience stress metrics.

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