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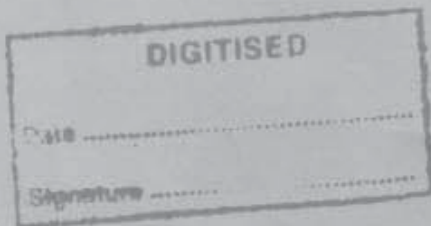
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**AUDITOR INDEPENDENCE, AUDIT FEES LOW-
BALLING, AND NON-AUDIT SERVICES:
EVIDENCE FROM A DEVELOPING MARKET**

by

Pranil Prasad

A thesis submitted in fulfilment of the requirements for the degree of
Master of Commerce

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March 2013

Declaration

Statement by Author

I declare that this thesis is my own work and that, to the best of my knowledge, it contains no materials previously published, or substantially overlapping with materials submitted for the award of any other degree at any institution, except where due acknowledgement is made in the text.

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The research in this thesis was performed under my supervision and to my knowledge is the sole work of Mr. Pranil Prasad.

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Abstract

The joint provision of audit and non-audit services remains a contentious issue for the regulators, legislators and the auditing profession to date. In the past two decades, audit research has examined whether the joint provision of audit and non-audit services impairs auditor independence. However, empirical evidence on non-audit services and auditor independence has remained mixed and inconclusive. In the wide range of studies conducted on non-audit services and auditor independence, many of the studies also investigated the market for non-audit services and in particular, the demand side of the market for non-audit services. These studies examined the factors that affect the decisions of clients to purchase non-audit services from their auditors. While a number of studies have examined the demand side of the market for non-audit services, few if any, audit research has examined the supply side of the market for non-audit services. This thesis seeks to contribute to the debate on the joint supply of audit and non-audit services by empirically investigating the supply side of the market for non-audit services. In particular, a model for the supply side of the market for non-audit services is developed and empirically tested. A supply side focus can be potentially informative because the reason why auditors supply non-audit services to their audit clients can have important implications for the independence of the auditor.

The supply side of the market for non-audit services is examined in the context of a developing economy. Whilst most of the research on non-audit services and auditor independence has been conducted in developed markets, it is an important issue in developing markets as well. There are differences between developed and developing markets in the area of financial reporting regulations, auditor appointment and dismissal regulations, corporate governance codes and most importantly differences in the regulation of the supply of non-audit services. There are also differences in the oversight of the audit function and the audit professional structure and standard setting between developed and developing economies. A developing economy focus will provide useful insights on the supply of non-audit services to the regulators, legislators, and auditors in these countries.

An ordinary least squares regression model is used to model the supply side of the market for non-audit services. In addition, a panel dataset is used. The data relates to the companies listed on the South Pacific Stock Exchange in Fiji from the year 1980 to 2010.

The results of this study indicate that auditors supply non-audit services to audit clients for opportunistic reasons, as audit fee low-balling is a significant factor explaining the supply of non-audit services. The variables, auditor tenure and auditor type are statistically insignificant in the model.

This study provides regulators and legislators in Fiji with important insights into the supply of non-audit services by incumbent auditors to their audit clients. The results reveal that auditors supply non-audit services to recover low-balled audit fees. This has implications for the independence of the auditors in the Fiji audit market. Thus, it is recommended that regulators and legislators in Fiji consider some form of regulation pertaining to the supply of non-audit services to improve and safeguard auditor independence. Regulations that depend on the market to regulate the supply of non-audit services will be ineffective because the capital market in Fiji is inactive.

The findings of this thesis provide empirical evidence on the factors affecting the supply of non-audit services. The results are potentially informative to the regulators, the legislators, the profession, and the audit firms operating in Fiji.

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List of abbreviations

AASC	Accounting and Auditing Standards Committee
AGM	Annual General Meeting
APESB	Accounting Professional Ethics Standards Board
APNAS	Auditor-Provided Non-Audit Services
ASR	Accounting Series Release
CA	Chartered Accountant
CEO	Chief Executive Officer
CLERP	Corporate Law Economic Reform Act
CMDA	Capital Markets Development Authority
COE	Code of Ethics
CPA	Chartered Practicing Accountants
CPP	Chartered Accountants in Public Practice
DA	Debt to Asset Ratio
E&Y	Ernst and Young
ERC	Earnings Response Coefficient
EU	European Union
FAS	Fiji Accounting Standards
FIA	Fiji Institute of Accountants
FNPF	Fiji National Provident Fund
FNU	Fiji National University
FOROPS	Foreign Operations
FRCA	Fiji Revenue and Customs Authority
FSA	Fiji Standards on Auditing
IAS	International Accounting Standards
IASB	International Accounting Standards Board
ICAA	Institute of Chartered Accountants Australia
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
INVREC	Inventory and Receivable Ratio
IPA	Institute of Professional Accountants
ISA	International Standards on Auditing

LIQ	Liquidity
LNAF	Natural Logarithm of Audit Fee
LNNASFEE	Natural Logarithm of Non-Audit Service Fee
LNTA	Natural Logarithm of Total Assets
MAS	Management Advisory Services
NAS	Non-Audit Services
NBF	National Bank of Fiji
NZ	New Zealand
NZX	New Zealand Exchange
OLS	Ordinary Least Squares
PWC	PriceWaterhouseCoopers
RBF	Reserve Bank of Fiji
ROA	Return on Assets
RTA	Registered Tax Agents
SEC	Securities and Exchange Commission
SME	Small and Medium Entities
SOX	Sarbanes-Oxley Act
SPICS	South Pacific Island Countries
SPSE	South Pacific Stock Exchange
SQSEG	Square Root of number of Business Segments
SQSUB	Square Root of number of Subsidiaries
TRB	Tax Registration Board
UK	United Kingdom
UOF	University of Fiji
US	United States
USP	The University of the South Pacific
VIF	Variance Inflation Factors

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CHAPTER 1: INTRODUCTION TO THE THESIS

1.1 Introduction

The supply of non-audit services by incumbent auditors has attracted significant attention from the regulators, academic community, and the public at large within the last decade. It is also an important issue for the accounting profession and corporate management. The regulators and legislators see the provision of non-audit services by incumbent auditors as a potential threat to independence (United States Congress 1977; Securities and Exchange Commission 1994, 2000; Panel on Audit Effectiveness 2000; Bainimarama 2011). The accounting profession sees non-audit services as a growing source of revenue stream (Hillison and Kennelley 1988; Houghton and Ikin 2001). The accounting profession and the regulators are at cross roads because of these differing views. In certain jurisdictions, regulators have introduced legislations restricting or banning auditors from supplying non-audit services to their audit clients, while in other jurisdictions legislations have been enacted that require corporations to publicly disclose the amount and type of non-audit services procured from the auditors.

Research examining non-audit services and its impact on auditor independence provide mixed results. The majority of the research on non-audit services has concentrated on the demand side, that is, reasons why clients purchase non-audit services from the auditors.

This thesis examines the supply side of the market for non-audit services. It provides empirical evidence on reasons why auditors supply non-audit services to their audit clients. The insights from the supply side of the market for non-audit services are potentially informative to regulators and legislators. These issues are examined in the context of a developing economy.

In order to provide a complete perspective of issues covered in this thesis, a brief review of the concept of auditor independence and its importance to the financial reporting process is explored in the next section.

1.2 Auditor independence

The independence of an auditor from clients' management is the mainstay of the audit profession. In the market place, auditors are appointed by the shareholders to provide an assurance that the financial statements presented by management are true and fair. The need for the shareholders to seek an independent auditor to provide this assurance arises because of the separation of management from the ownership of the entity - the common business structure where the shareholders appoint a management team to operate the business on their behalf. This separation of the ownership of an entity from its management creates what is referred to as, the agency problem. The shareholders pass the reins of the business to the management team with the expectation that they will operate the business in their best interest. As part of the monitoring process, the shareholders require the management team to provide them with regular financial reports. The management team has incentives to act in their own best interest; therefore, any reporting by management to shareholders may be compromised. The shareholders, as a result, rely on an independent third party – the auditor to provide an assurance that the financial statements provide a true and fair view of the entity's performance and position.

The auditors' opinion will only be valuable to the owners of an entity if the auditor remains independent of the management. It is also very important for an auditor to appear to be independent from the clients' management. Regulators note that the public confidence in the auditors may be lost if there is evidence that independence is actually lacking and confidence may be lost if there are circumstances which leads a reasonable person to believe that independence is lacking. Various circumstances may lead to the impairment of the independence of an auditor. One of the circumstances is the provision of non-audit services alongside audit services. The provision of non-audit services is the

focus of this study, as a result, an overview of non-audit services and its impact on audit independence is provided in the next section.

1.3 An overview of non-audit services

Non-audit services include all services provided to an audit client apart from financial statement audit. These other services may include bookkeeping services, taxation services, actuarial services, valuation services, internal auditing, and accounting information systems design and implementation. In the literature, non-audit services are referred to by various names such as management advisory services and management consulting services. However, non-audit services is not limited to consulting or advisory but also includes compliance related services (such as taxation and accounting advice) and assurance related services (such as internal auditing).

An audit client can purchase non-audit services from the incumbent auditor or other providers of such services. It is the auditor provided non-audit services that this study is concerned with. Non-audit services purchased from other service providers other than the incumbent auditor do not pose any problems for auditor independence.

1.3.1 Impact of non-audit services on auditor independence

The joint provision of audit and non-audit services impairs an auditor's independence in two ways, first, through the self-review of services provided through its non-audit engagement and second, through the economic dependence on non-audit service fee. The self-review threat arises when an auditor has to evaluate the results of a previous judgment or service. In the case of non-audit services, an auditor may be required to evaluate and provide assurance on subject matter that is directly influenced by advice and potentially decisions that were made based on the auditors' capacity as non-audit service provider. In case the auditor discovers any issues with the subject matter in the course of the audit, the question then, is whether the auditor will be willing to bring the

issues to the fore given the costs associated with such an action. The major cost being the loss of reputational capital as non-audit service provider.

An additional issue with joint provision is that the auditor is actually serving two different clients (Ye et al. 2011). The shareholders are the clients for audit services while the management is the client for non-audit services. This leads to a conflict of interest for the auditor.

The joint provision of audit and non-audit services also leads to economic bonding between the auditor and the client through fee dependency. The non-audit services are more lucrative with higher margin than audit services. The audit services market is also saturated and competition is high, therefore, audit firms rely on revenue from non-audit services for growth (Hillison and Kennelley 1988). The non-audit service market also becomes a risk diversion strategy for audit firms especially in market conditions where litigation against auditors has been high and the loss due to the litigation claims far more than the audit fees paid by clients. The high competition in the audit market and the saturation of the audit market also leads to audit fee low-balling. Audit fee low-balling occurs when an auditor sets the fee for an audit below the cost of conducting the audit. Audit fee low-balling is not observable directly as the cost of audit is not public information. Thus, previous studies investigating audit fee low-balling rely on other indicators. One of the indicators is comparing the audit fee in the year a new auditor is appointed with the audit fee in the previous year; any decline (discount) in audit fee makes it more likely that there is low-balling.

Simon and Francis (1988) and Ettredge and Greenberg (1990) document initial year audit fee discounting using data from the United States (U.S.) audit market. On the other hand, Craswell and Francis (1999) fail to find evidence of audit fee discounting using Australian data. They attribute this result to the requirement in Australia for firms to disclose audit and non-audit fee in the annual reports, something that was not required in the U.S. when Simon and Francis (1988) and Ettredge and Greenberg (1990) conducted their study. However, the argument put forth by Craswell and Francis (1999)

do not hold up as a more recent study by Sankaraguruswamy and Whisenant (2005) documents audit fee discounting even after public disclosures of audit and non-audit fee were made mandatory in the U.S. In another study, Ghosh and Lustgarten (2006) also document audit fee discounting using U.S. data.

Audit fee low-balling creates concerns for auditor independence. When an auditor low-balls audit fee, it expects to recover the low-balled audit fee in the future. Since the auditor expects to recover the low-balled audit fees, it has an interest in retaining the audit client in the future and this may mean going along with the demands of the audit client in order to maintain the auditor-client relationship (Geiger and Raghunandan 2002). Low-balling may also lead an auditor to reduce the audit effort, which could lead to a lower quality audit.

Audit fee low-balling becomes even more problematic when an auditor provides both audit and non-audit services to the same client. In the presence of non-audit services, an auditor may low-ball audit fees and expect to recover the low-balled audit fee from the subsequent provision of non-audit services. Auditors also know that once they get the contract to provide audit services they will be able to get non-audit work from the client. Research shows that clients usually turn to their auditor to procure non-audit services (Hillison and Kennelley 1988). Empirical evidence suggests that in the U.S., audit fee discounting was more prevalent before restrictions were placed on auditor provided non-audit services through the enactment of the Sarbanes-Oxley Act of 2002 (SOX) (Huang et al. 2009). In the periods before SOX was enacted, initial year audit fee discounting of 24 percent were present (year 2001) while in the periods after SOX (year 2005-2006) the discounting of audit fee disappeared completely and premiums were charged for initial year audits. One of the explanations given for the disappearance of audit fee low-balling is that auditors would be pricing audit as standalone service post-SOX due to the restrictions placed on non-audit services. This suggests that when setting fees for audit services auditors did consider the future prospects of providing non-audit services to the client and that the pricing of audit services is influenced by the expectation of future non-audit service contracts.

Regulators in many jurisdictions viewed joint provision and audit fee low-balling as a potential impairment to the auditors' independence (see for example Securities and Exchange Commission (SEC) 2000), and responded by regulating the amount and type of non-audit service that an auditor can supply its audit clients. The regulatory responses of selected jurisdictions are discussed in the next subsection.

1.3.2 Regulation of non-audit services

In the interest of safe guarding auditor independence and in response to large-scale corporate collapses, various jurisdictions imposed legislations on auditor provided non-audit services. In 2001, Enron one of the largest corporations in the U.S. filed for bankruptcy (Jones 2011). One of the major factors leading to the failure of Enron was fraudulent financial reporting and the failure of the audit mechanism (Jones 2011). The regulators were also concerned with the amount of fees paid to the auditors of Enron for non-audit services. In light of concerns and failures, the legislators in U.S. enacted legislations to improve the overall governance of corporations. In 2002, SOX was enacted and contained guidelines and rules on various issues relating to corporate governance. One of the areas covered by this legislation was auditor independence. The rules in SOX included a blanket ban on many auditor provided non-audit services. The auditors could still provide some non-audit services but these were restricted to a certain amount. The ban on many types of non-audit services was to eliminate self-review threat, while restriction of some non-audit services to a certain amount was supposed to minimize fee dependency and self-interest threats. The SOX worked by restricting the supply of non-audit services, thus affecting the supply side of the market for non-audit services.

The U.S. had regulations governing non-audit services in the pre-SOX era as well. In the year 2000, the SEC through the auditor independence rules required firms to disclose the amount and type of non-audit services procured from the incumbent auditor. The disclosure regulations would enable the market to decide and take relevant

action on the purchase of non-audit services by firms from their incumbent auditors. The disclosure regulations were designed to affect the demand side of the market for non-audit services. If the market feels that the amount and type of non-audit services procured by firms from their auditors is likely to impair the independence of the auditors then the market would discipline firms. The firms would then react by reducing or eliminating the purchase of non-audit services from incumbent auditors. Abbott et al. (2011) provides evidence that the disclosure regulation on non-audit services were actually functioning.

Australia also enacted legislations containing provisions to enhance auditor independence in the form of the Corporate Law Economic Reform Act 9 of 2004 (CLERP 9). However, unlike the U.S., Australia did not ban the joint provision of audit and non-audit services. It rather required firms to disclose in the annual reports the fees paid for non-audit services provided by the auditor during the financial year. In addition, it also required the directors to make a statement that they are satisfied that the provision of non-audit services does not affect the independence of the auditor.

In Canada, the rules of professional conduct that is administered by the Institute of Chartered Accountants, provides guidelines on the joint supply of audit and non-audit services. The rules in Canada do not directly ban the joint provision of audit and non-audit services. However, if a firm intends to procure both audit and non-audit services from its auditor then there are certain conditions that need to be satisfied. The failure to satisfy conditions outlined in the rules of professional conduct would mean that a firm would not be able to procure both the services from the same supplier.

The European Union (E.U.) including United Kingdom (U.K.) adopted guidelines similar to that issued by International Federation of Accountants (IFAC). IFAC rules do not ban the provision of non-audit services but require the disclosure of fees paid.

In the list of countries examined, U.S. is the only jurisdiction that bans certain types of non-audit services; Canada comes close to the U.S., by requiring a number of conditions

to be met before auditors can supply certain types of non-audit services. Australia, U.K., and the E.U. member countries do not ban auditor provided non-audit services but require the disclosure of the type of non-audit services and the amount of non-audit services procured. These countries unlike the U.S. rely on the market to discipline non-audit service purchasers and regulate auditor supplied non-audit services.

Auditors claim that the ban and restrictions on the supply of non-audit services are counter-productive and that there are efficiencies to be gained from the joint supply of audit and non-audit services. An examination of the claims made by the auditors in favour of joint supply of audit and non-audit services follows in the next section.

1.3.3 Auditors response to joint supply of audit and non-audit services

The accounting profession claims that regulations that restrict the supply of non-audit services are inefficient because joint provision does not impair their independence; rather, it leads to more efficient and effective audits (Johnson et al. 2002; Myers et al. 2003; Ghosh and Moon 2005). The profession's arguments are based on the notions of knowledge spillovers from non-audit to audit services and vice versa (Krishnan and Yu 2011).

Empirical evidence on knowledge spillovers from non-audit services to audit and vice versa provide mixed results. The most recent research on knowledge spillovers between non-audit services and audit services conducted by Knechel and Sharma (2012) provide some insights and empirical evidence. Knechel and Sharma (2012) study the impact of joint provision of audit and non-audit services on audit report lags. The results of this study indicate that the higher the amount of non-audit services supplied by the auditor the shorter the time between the financial year-end date and the audit report date. The authors take this as an indication of knowledge spillover. The results of Knechel and Sharma (2012) are limited to non-audit services and audit services being provided by the same audit office in a particular city. On the other hand, there are studies that provide evidence that non-audit services does not lead to knowledge spillovers. Hay et

al. (2006) document no relationship between non-audit services and going concern audit opinions, which indicate that knowledge spillovers do not exist. If knowledge spillovers existed, the provision of non-audit services would have lead to the auditors having a greater ability to detect going concern problems in businesses they audit, resulting in a significant positive relationship between non-audit services and going concern audit opinions.

Various other studies have examined the knowledge spillover phenomenon between audit and non-audit services since the 1980's. The results of these studies are mixed at best as some report that knowledge spillovers exists and others report that no knowledge spillovers exist between audit and non-audit services (see for example Simunic 1980; Palmrose 1986; Abdel-khalik 1990; Davis et al. 1993; O'Keefe et al. 1994; Knechel and Payne 2001; Knechel et al. 2009; Gaeremynck et al. 2010).

The empirical evidence on non-audit services and auditor independence remain mixed and inconclusive at this time. Research studies examining the effects of knowledge spillovers between audit and non-audit services also fail to provide conclusive results. On one hand, the regulators and legislators have imposed legislations banning and restricting the provision of non-audit services and on the other, the audit profession is claiming that the joint provision of audit and non-audit services are not a threat to their independence. In the wide range of studies conducted on non-audit services and auditor independence, many of the studies examined the market for non-audit services and in particular, the demand side of the market for non-audit services. These studies examined the factors that affect the decisions of clients to purchase non-audit services from their auditors. While a number of studies have examined the demand side of the market for non-audit services, few if any, audit research has examined the supply side of the market for non-audit services. A supply side focus can be potentially informative because the reason why auditors supply non-audit services to their audit clients can have important implications for the independence of the auditor. This thesis seeks to contribute to the debate on the joint supply of audit and non-audit services by empirically investigating the supply side of the market for non-audit services. In

particular, a model for the supply side of the market for non-audit services is developed and empirically tested. The supply side of the market for non-audit services is examined in the context of a developing economy. While most of the research on non-audit services and auditor independence has been conducted in developed markets, it is an important issue in developing markets as well. A developing economy focus will provide useful insights on the supply of non-audit services to the regulators, legislators, and auditors in these countries. The factors and issues affecting the supply side of the market for non-audit services are presented in the next section together with the motivation for examining these issues in the context of a developing economy.

1.4 The supply side of the market for non-audit services

A range of factors affects the supply of non-audit services. The effects of a globalised world and ever-increasing complexity of businesses drive the demand for a wide range of consultancy services. Thus, an auditor may supply non-audit services to its audit client because the client needs the services and prefers to procure these services from the auditor.

In addition to satisfying the client's needs, an audit firm may supply non-audit services to broaden its revenue base and to maintain a steady growth of the practice. This is even more important at a time when the saturation of the audit market means audit services may not contribute significantly to growth of the audit firm. On the same note, audit firms may low-ball audit fee to get their foot into the door. In the case where the audit has been a loss leader, the auditor may supply non-audit services to recover the losses.

The knowledge base that an audit firm possesses together with the technical capabilities may also influence the supply of non-audit services. If an audit firm does not possess the required expertise and the capability to provide the required non-audit services then it will not be able to supply these services to its audit clients. This is, as a result, an important determinant of non-audit services supply.

Three distinct reasons have been identified as to why an auditor may supply non-audit services to its audit clients. If the auditor supplies non-audit services to maintain a steady growth of the firm or to recover low-balled audit fee, this may have negative implications for the independence of the auditor. An audit firm that low-balled audit fee to get its foot into the door may expect to recover the low-balled audit fee from subsequent non-audit service engagements and this may lead the auditor to be more lenient towards the audit client just to maintain the auditor-client relationship. This reason for the supply of non-audit services is also opportunistic, as the auditor sees the provision of non-audit services as an opportunity to recover low-balled audit fees.

On the other hand, if the auditor supplies non-audit services to its audit clients because it possesses the requisite knowledge, capabilities, and technical competence then it is economically efficient. In many cases, an auditor may have better knowledge of the client's needs and business and is able to provide better services at lower costs compared to other suppliers. This may be a result of knowledge spillovers.

If auditors supply non-audit services for efficiency reasons than imposing legislations to restrict the supply may be counter-productive. However, if an auditor supplies non-audit services for opportunistic reasons then legislations curtailing the supply may be a move in the right direction. As stated in the previous section, this thesis seeks to provide empirical evidence on this issue. The motivation for this study comes from the need to provide some closure to the debate on the joint supply of audit and non-audit services. This thesis also uses a developing economy context to examine these issues. The developing country chosen for this study is Fiji. There are various reasons for choosing a developing economy context and in particular Fiji.

Fiji is chosen as the location for this study given the lack of regulations on the supply of non-audit services. Auditors in Fiji can supply non-audit services to their audit clients without restriction. This gives us a unique setting as most other jurisdictions have some form of legislation that affects the supply of non-audit services by incumbent auditors. In order to effectively model the supply side of the market for non-audit services it is

important that the effects of regulatory interventions are minimal. In case there are any regulatory interventions in the market for non-audit services, these would obscure the results.

This market setting also enables us to investigate the issue of non-audit services in a developing market. The stock market in Fiji is inactive (Mala and White 2006; Mala and White 2009). Information is not efficiently incorporated into market trading activities. This has important implications for legislators and regulations that depend on the market to discipline market participants and firms. For instance, many developed countries do not ban non-audit services but require firms to disclose the amount and type of non-audit services procured from the auditor publicly. The presumption of such regulations is that the market will take action against firms if the market feels that the provision of non-audit services by incumbent auditors will affect auditor independence. In a market like Fiji, with an inactive stock market, the reliance on market mechanisms to correct the market are ineffective. Therefore, regulations that depend on the market will not be suitable.

The audit market is also highly concentrated with 12 out of 16 (75 per cent) listed companies being audited by the Big 4 auditors in Fiji. While, this is common, the Big 4 concentration is lower in many developed countries around the world (see for example Francis et al. 2012). The listed company audit market is also saturated and competition is high. This has implications for low-balling of audit fees.

Fiji has also seen its fair share of corporate failures, including major financial scandals. The failure of the then National Bank of Fiji (NBF) in the early 1990's was very costly for Fiji where the government had to bail out the Bank. Losses were in the proximity of \$FJD 220 million (Grynberg et al. 2002). In recent times, a number of major financial scandals have come to light, including the agricultural fraud (Fiji Times Limited 2008). The local superannuation fund also faced significant losses due to write-downs in its investment (Fiji National Provident Fund 2009). The fact is that, Fiji, being a relatively small economy is not immune to financial mismanagement. In a recent address to the

accountants, the Prime Minister of Fiji also pointed out a number of issues in relation to independence of auditors and instances where auditor independence was seen to be impaired, but there were no action being taken by the profession including issues related to joint supply of audit and non-audit services. In his address, the Prime Minister pointed out that:

“Institutional failures or failures within institutions where auditors for example continued to provide positive feedback simply to receive fees; or there was the blurring between auditing and accounting services, demonstrates, amongst other things, that there are serious problems with respect to monitoring and enforcing the standards and code of ethics.” (Bainimarama 2011).

The government through the address demonstrated the concerns that are there regarding the profession. Quite clearly stated in the address is the fact that in Fiji there is a blurring between audit services provided by accountants and other services. The concerns of the government further motivate this study to investigate the reasons for the supply of non-audit services by auditors to their audit clients in Fiji.

The accounting profession in Fiji is also self-regulated. The accountants issue accounting standards and ethical pronouncements to be followed by the profession. The enforcement of these standards and ethical pronouncements also lies with the profession. While, self-regulation may seem like an easy way to regulate a profession and many countries around the world did have a self-regulating accounting profession, the trend is now changing towards independent regulation. The U.S., Australia, U.K. and many other countries have established institutions that regulate accountants and accounting services. This study takes all these unique features of the Fiji listed company audit market into account. In the next section, the specific objectives of this study along with the contributions and findings are discussed.

1.5 Objectives and contributions of this thesis

The objective of this study is twofold. The first objective is to examine the factors that affect the supply side of the market for non-audit services. The second objective is to examine these issues in the context of a developing economy and in particular Fiji.

The results of this study will provide legislators and regulators in Fiji with empirical evidence that will enable them to make informed decisions regarding the regulation of the joint supply of audit and non-audit services. Currently, the financial reporting regulatory environment in Fiji is weak. There have been major financial reporting problems and issues of auditor independence.

This thesis also contributes to the audit and non-audit service and auditor independence literature in a number of ways. Prior studies investigate the impact of non-audit services on auditor independence. They investigate the impact non-audit services has on various independence proxies including earnings management, and auditor opinion. Results from most studies on non-audit services and independence find no significant relationship. A limited number of research studies model the demand side of the market for non-audit services. However, no prior study has modelled or examined the supply side of the market for non-audit services. Thus, this study extends the non-audit service literature by developing a model for the supply side of the market for non-audit services, which will enable us to understand why auditors supply non-audit services to audit clients. This model in conjunction with the non-audit services demand model will provide more insights into the joint demand and supply of audit and non-audit services (Houghton and Ikin 2001).

This research will also improve the external validity of studies related to joint supply of audit and non-audit services. All prior studies in this area have focused on developed or emerging economies where market conditions and regulatory environments are very different. The case for developing economies like Fiji is quite different. The Big 4 firms dominate the market for audit services. The accounting profession is self-regulated. The

stock markets are inactive and there is a complete absence of independent regulatory oversight. These differences provide a unique setting in which to investigate issues of joint supply of audit and non-audit services.

The results of this study indicate that auditors supply non-audit services to audit clients for opportunistic reasons, as audit fee low-balling is a significant factor explaining the supply of non-audit services. The variables auditor tenure and auditor type are statistically insignificant in the model. These two variables represented efficient reasons for an auditor to supply non-audit services to its audit clients.

The results reveal that auditors supply non-audit services to recover low-balled audit fees. This has implications for the independence of the auditors in the Fiji audit market. It is recommended that regulators and legislators in Fiji consider some form of regulation pertaining to the supply of non-audit services to improve and safeguard auditor independence. Regulations depending on the market to regulate the supply of non-audit services will be ineffective because the capital market in Fiji is inactive. Thus, direct regulatory intervention is necessary. The final section of this chapter provides an overview of how the rest of this thesis is organised.

1.6 Organisation of the thesis

The rest of the thesis is organised as follows:

- Chapter 2 provides an overview and analysis of the market for audit services in Fiji.
- Chapter 3 provides an overview of the prior literature on non-audit services and auditor independence followed by the hypotheses.
- Chapter 4 presents the research methods employed in this thesis.
- Chapter 5 presents the results followed by the analyses and discussion of the results.
- The final chapter of this thesis presents the conclusions and policy recommendations emanating from the findings. The limitations of this study along with avenues for future research are also presented in this final chapter.

CHAPTER 2: AN OVERVIEW OF THE AUDIT MARKET IN FIJI

2.1 Introduction

The accounting profession in Fiji is self-regulated. The sole professional membership body for accountants in the country, the Fiji Institute of Accountants (FIA) is responsible for setting accounting standards and the professional ethical requirements. The Institute is also responsible for the enforcement of the standards and the ethical pronouncements. This arrangement has led many including the government, and other relevant stakeholders to raise concerns about the apparent conflict of interest. The Prime Minister of Fiji in his address to the accountants at the 2011 annual FIA Congress said that:

“In Fiji, the sole responsibility of producing and issuing accounting standards rests with the Fiji Institute of Accountants (“FIA”). While FIA is charged with awarding professional membership to accountants and auditors, it is at the same time also responsible for setting accounting standards and regulating the conduct of its members. In effect, the members of the FIA are responsible for judging their own members for professional misconduct and for breaches of accounting standards established by them.”

“In a similar vein, it is necessary that the conduct of the accounting profession, accounting firms, and the auditors be scrutinized by an independent institution.”
(Bainimarama 2011).

The statement at the annual congress indicates the government’s position on the issue of the regulation of accounting and auditing in Fiji. In this chapter, issues related to the regulation of accounting and auditing in Fiji is explored. In addition, a historical perspective on the development of the accounting profession is provided. The establishment of the tax agents’ board and the public accountants’ registration board and finally the enactment of the FIA Act in 1972, which lead to the establishment of FIA, are examined in detail. An analysis of the regulation of accounting through the

corporate law and accounting standards enables the provision of a number of recommendations that would lead to improvements in the financial reporting process in the country. The examination of the accounting and auditing environment also provides a context within which the issue of the joint supply of audit and non-audit services is examined in Fiji. The next section starts by providing a background on the development of the accounting profession in Fiji.

2.2 Development of the accounting profession

The accounting profession in Fiji was largely unregulated until the government accepted a proposal to register tax agents in the 1940's. There were only a few accountants with professional qualifications at this time. The unregulated nature of the profession also meant that anyone could open up a practice to provide accounting services. The formation of the tax registration board provided some formality to the accounting profession. The tax agents' board still exists to date and is managed by the Fiji Revenue and Customs Authority (FRCA). It is empowered to register individuals as Registered Tax Agents (RTAs). The RTAs can provide advice to clients on taxation matters. The RTAs can also provide accountancy services but only to the extent that such services are required for tax purposes. While the tax agents' board provided some formality to accounting in Fiji, it was still not a professional accountancy body. Accounting was still largely unregulated, and accountants were still unregistered. There was a need for a professional accounting body in Fiji that would be responsible for the registration and regulation of accounting.

The Public Accountants Registration Board was established in 1962. There were three members on this board including a registrar and two members appointed by the government. The main function of this board was to register all accountants practicing in Fiji. The board faced various challenges including slow growth in membership numbers. The slow growth in membership over a decade from the inception of the Public Accountants Registration Board prompted the government to establish the Fiji Institute of Accountants. The Institute was established through the enactment of the Fiji

Institute of Accountants Act in 1972. The Institute’s role was similar to the role of the Public Accountants Registration Board. However, this time the accountants themselves were given the power to appoint the members who would serve on the institutes’ council. The next section looks the role of FIA, its governance structure, funding, and the efficacy of accounting regulations.

2.3 The Fiji Institute of Accountants

The institute was established in 1972 and its main role at the time was to register accountants in Fiji. Over the years, FIA has been very successful in enrolling members. While the primary role of FIA is to register accountants, through the various by-laws FIA was also given the responsibility to issue and enforce accounting, auditing, and ethical standards. The next subsection provides a discussion on the governance of FIA and the composition of the FIA council.

2.3.1 Governance and council membership of FIA

The governance framework for the Fiji Institute of Accountants is stipulated in the FIA act and the by-laws. The act states that a council appointed by its members and approved by the relevant minister will govern the institute. Thus, a nine-member council governs the institute. The FIA council is lead by the president and assisted by the vice president. Table 2.1 presents the members of the FIA council for the past four years:

TABLE 2.1

Fiji Institute of Accountants council membership 2008-2011

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
President	Iowane N.	Iowane N.	Uday Sen	Divik Deo
V. President	Rajeshwar S.	Uday Sen	Divik Deo	Camacakau R.
Treasurer	Sikeli T.	Sikeli T.	Sikeli T.	Sikeli T.

TABLE 2.1 (continued)

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Member 1	Lisa Apted	Lisa Apted	Lisa Apted	Lisa Apted
Member 2	Nitin Gandhi	Nitin Gandhi	Nitin Gandhi	Nitin Gadhi
Member 3	Pradeep Patel	Regina Mar	Ashwin Singh	Iowane Naiveli
Member 4	Deo Sharan	Divik Deo	Stella Simpson	Uday Sen
Member 5	Uday Sen	Cama R.	Iowane Naiveli	Stella Simpson
Member 6	Susan Kumar	Ashwin Singh	Camacakau R.	Atunaisa N.

Source: FIA Annual Report 2008, 2009, 2010, and 2011

There are various committees that serve the council. The council selects the members of these committees and a council member heads each committee. There are currently 14 committees of the council (Fiji Institute of Accountants 2010). The standard setting committee and the disciplinary committee are two of the most important committees of the institute. The standard setting committee deals with the regulation of accounting, auditing, and accountants in Fiji while the disciplinary committee deals with the enforcement of the standards and codes of professional conduct. These committees are examined later when the regulation of accounting in Fiji is examined.

2.3.2 Membership and funding

2.3.2.1 Membership

The establishment of FIA in 1972 saw a growth in membership numbers through the years. The total membership number now stands at 742. There are six categories of membership and includes Chartered Accountants in Public Practice (CPP), Chartered Accountants (CA), provisional members, affiliate accountants, licensed accountants, and student members. Table 2.2 provides the membership numbers by category as at December 2011.

TABLE 2.2**Fiji Institute of Accountants membership by category**

<u>Category</u>	<u>Numbers</u>	<u>Percentage</u>
Chartered Accountants in Public Practice	37	04.99
Chartered Accountants	258	34.78
Provisional Accountants	263	35.44
Affiliate Accountants	153	20.62
Licensed Accountants	1	00.13
Student Members	30	04.04
Total	742	100.00

Source: FIA Annual Report 2011.

Individuals seeking membership of the institute have to complete the educational requirements stipulated by the council. Admission to the CA category also requires the completion of four postgraduate courses in accounting from the University of the South Pacific (USP) or four professional level courses offered by CPA Australia in addition to the practical work experience requirement. In principle, undergraduate courses offered by USP, the University of Fiji (UOF) and the Fiji National University (FNU) are accredited for membership.

2.3.2.2 Funding and operations

The Fiji Institute of Accountants office is located in the capital city of Fiji - Suva. A high percentage of the Institutes members are also located in Suva and Lautoka. Both these cities are located on the main Island in the Fiji group. In order to cater for its members located in and around Lautoka the institutes council has formed a committee made up of members from Lautoka and its neighbouring townships.

The institute's major sources of funding are admission and membership fees and the annual congress. The annual congress is a major event in the institute's calendar. At present the annual congress has very little to do with accounting, auditing and accountants. It is more like a business get-together. The focus is also on the sponsors in

the annual congress. The FIA council recognizes this issue with the annual congress on its corporate website and plans to bring about changes. However, a review of the strategies put forth by FIA to improve the congress reads, “Improve value of Congress to sponsors and delegates”. The strategy put forth by the council to improve the congress for the accountants in Fiji still states that the congress should provide value to “sponsors” and “delegates”. The focus is again on sponsors. One of the reasons for the focus on sponsors is because the institute is dependent on the funds raised from the congress for its operations. Sponsors are a major contributor of the funding for the annual congress either by sponsoring delegates to attend the conference or through direct sponsorship of the congress. The funding model for accounting professional bodies is quite different in developed countries, where such institutes depend on revenues from professional development training for funding of operations in addition to annual membership fees (see for instance CPA Australia Limited 2011). The provision of professional education and continuing professional development training services represents a minor source of revenue for the institute. However, the provision of continuing professional development training is an important responsibility of the institute.

2.4 The supply of accounting and auditing services

A number of international and local accounting firms offer accounting and auditing services in Fiji. At present, three of the Big 4 international accounting firms are offering accounting and auditing services in Fiji. Apart from the three Big 4 international accounting firms, there is one non-Big 4 international accounting firm, 20 local accounting firms, and 21 tax agents operating in Fiji according to the Fiji business directory for 2011.

The Big 4 provide a wide range of audit and non-audit services to their clients. The local accounting firms also provide a range of services including audit services. The tax agents are only permitted to provide taxation related services. They may provide accounting services only to the extent that it relates to the tax work they are doing.

The listed company audit market is highly concentrated, as the Big 4 audited 12 of the 16 listed companies in 2010. The data also indicates that this concentration was even higher when the fourth Big 4 audit firm was operating in Fiji. A national accounting firm currently audits the other four listed companies. Table 2.3 provides an analysis of the listed company audit market segmentation for Fiji. PriceWaterhouseCoopers (PWC) holds the largest market share both by number of clients and by the amount of audit fee earned. More than 50% of the audit fees paid by listed companies accrue to PWC. While PWC has the highest market share, KPMG’s market share is the smallest. Quite surprisingly, G. Lal the only national accounting firm auditing listed companies in Fiji holds the third largest market share while Ernst and Young (E&Y) holds the second largest market share.

TABLE 2.3

Listed company audit market segmentation in Fiji¹

<u>Audit firm</u>	<u>Number of audits %</u>	<u>Audit fee %</u>
PriceWaterhouseCoopers	31.25	50.30
Ernst & Young	25.00	19.95
G. Lal	25.00	14.88
KPMG	18.75	14.87
	100.00	100.00

¹This analysis is presented on data related to the year 2010.

2.5 Regulation of accounting and auditing practices

There are three sources of financial reporting regulations in Fiji. These include the company’s law, accounting, and auditing standards and the stock exchange listing requirements. The ethical standards issued by the accounting profession govern the conduct of accountants.

2.5.1 Company law

The Fiji Companies Act (referred as ‘the act’ hereafter) is the legislation that governs’ the company form of business in Fiji and is administered by the State. The Act, amongst other things covers financial reporting by companies in Fiji. This Act was enacted in 1983 and revised in 1985 after which no further amendments or revisions were made. The government has identified this legislation as archaic and as a result, started the process of modernizing the Act. In 2011, a draft of the revised Act was released; however, the new Act is still to be enacted as legislation.

The provisions governing financial reporting and auditing by companies is covered in sections 149, 151, 152, 161 and the seventh schedule of the Fiji Companies Act. The Act states that financial reports presented by the management of a company must present a true and fair view of its state of affairs. There is no further guidance on this issue in the Act. In the same spirit, the Act does not mandate the use of accounting standards by firms preparing financial statements. Regardless of the absence of guidance on application of accounting standards, entities preparing financial statements do apply accounting standards. This is because accountants preparing financial reports are bound by the requirement by FIA for their members to apply standards issued by it. Listed companies apply accounting standards as they are mandated to do so by the stock exchange listing rules.

As might be expected, disclosure requirements contained in the Companies Act deal with issues that shareholders have a legal right to know. For example, the seventh schedule of the Fiji Companies Act states that the auditors’ remuneration must be disclosed. It is one of the few expenses that must be disclosed separately in the financial reports. This expense must be disclosed because the shareholders, not the company, appoints the auditors, and they must take responsibility for the cost.

The Companies Act outlines requirements for the audit of a company. Section 161 of the Act states that an auditor needs to be appointed at the Annual General Meeting

(AGM) of the company. However, the Companies Act only goes so far as the appointment and dismissal of the auditor. The Act does not contain any guidelines on auditor independence. The Australian Corporations' Law, on the other hand, contains specific guidelines on the independence of auditor. This is a weakness of the current Companies Act in Fiji.

The Act needs to be modernized and provisions related to auditor appointment and dismissal revised. A number of new provisions on auditor independence need to be added. The current Companies Act also needs an update of other sections including an overall revision of the general guidelines on corporate governance. Accounting standards need to be made mandatory through the Companies Act. These changes will strengthen the financial reporting practices in Fiji.

2.5.2 Accounting and auditing standards

The Accounting and Auditing Standards Committee (AASC) is a sub-committee of the FIA council. It reviews and makes recommendations to FIA council on appropriate accounting and auditing standards. The council then makes a decision on the adoption of the proposed accounting and auditing standards. The role this committee plays in the regulation of accounting and auditing in Fiji is very important. FIA was given the responsibility to issue accounting and auditing standards by the government through the FIA by-laws in the 1980's. These by-laws conferred self-regulating rights on the accountants. Table 2.4 provides the list of members serving or having served the FIA accounting and auditing standards committee from 2008 to 2011.

TABLE 2.4

Membership of accounting and auditing standards committee of FIA 2008-2011

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Chair	Iowane Naiveli	Sikeli T.	Sikeli T.	Sikeli T.
Member	Bruce Sutton	Bruce Sutton	Bruce Sutton	Bruce Sutton

TABLE 2.4 (continued)

	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Member	Eroni Vatuloka	Eroni Vatuloka	Tevita B.	Iowane Naiveli
Member	Michael White	Michael White	Michael White	Michael White
Member	Urmila Maharaj	Naushad Ali	Naushad Ali	Tevita B.
Member	Naushad Ali	-	Inia Naiyaga	Inia Naiyaga

Source: FIA Annual report for 2008, 2009, 2010, and 2011.

Table 2.4 shows that in 2011 the committee had six members with two of the six members coming from the Big 4 accounting firms. The third member is from a local accounting firm while the fourth member is from the academic community. The auditor general's office is also represented on this committee through the fifth member. The sixth member of this committee came from the private sector. While this seems to be a diverse group, the members are all from the accounting community. Accounting and auditing standards play an important role in society. They are there to safeguard the interest of a range of stakeholders. However, these stakeholders are not part of the process of standard setting nor are they represented in the process in any way. A more inclusive approach to standard setting will lead to processes that are more transparent and ensure that the needs of the stakeholders are taken into consideration in this very important process of standard setting.

2.5.2.1 Accounting standards

The FIA began issuing non-mandatory recommendations on accounting practice immediately after its inception in 1972. The first Fiji Accounting Standards (FASs) were issued in 1976. In 1999, FIA agreed to adopt (with some exceptions) International Accounting Standards (IASs) as the basis for a completely revised set of FASs. In 2001, a revised set of FASs were issued for application from January 2001 but this was later postponed to July 2001. The FIA later agreed to adopt the full suite of International Financial Reporting Standards (IFRSs) issued by International Accounting Standards Board (IASB). In principle, entities, which were publically accountable and listed, were

required to follow IFRS. The Small and Medium Entities (SMEs) were to continue applying the existing FASs while the IASB worked on the IFRS for SMEs. In 2009, the IFRS for SMEs were released and entities were required to comply with these standards from January 2011.

An analysis of listed company financial statements reveal that all of the entities prepare their financial statements in compliance with IFRS; some starting as early as 2006, while others starting in 2007 or 2008. It is too early to evaluate the application of IFRS for SMEs in Fiji at this time.

2.5.2.2 Auditing standards

The FIA has adopted the International Standards on Auditing (ISA) as the auditing standards in Fiji, as was the case with the accounting standards. The International Federation of Accountants (IFAC) develops and issues ISAs.

Prior to adopting the ISAs, FIA had developed the Fiji Standards on Auditing (FSA) that were largely based on the ISAs and auditing standards of Australia and New Zealand. With the harmonization of the accounting standards complete at the end of 2001, the institute worked on harmonizing the auditing standards in 2002. Fiji standards on auditing, which were based on the 2001 version of ISAs, were issued by FIA after the completion of the harmonization process in 2003. The FSAs were to be harmonized with the ISAs every three years. In 2006, FIA decided to adopt the ISAs as the auditing standards in Fiji.

2.5.3 Code of ethics for professional accountants

The FIA developed and adopted the FIA ethical rulings to regulate members' conduct in September 1979. Due to changing environment, growth in membership and the complexity of the assignments being undertaken by accountants, the institute decided to review the ethical rulings in the late 1990s. The review was completed in the year 2000

and a new code of ethics (COE) was issued. The new COE was partly based on the old ethical rulings but also drew on the IFAC's code of ethics.

In 2005, FIA decided to adopt the IFAC code of ethics in a bid to honour its commitment to IFAC. The new code was to be effectively applied from July 2008. Since the IFAC code did not cover certain activities of the accounting profession in Fiji, FIA also issued a supplementary code of ethics to provide guidance on issues unique to the profession in Fiji.

The enforcement of the code of ethics also rests with the FIA. The institute's investigation and disciplinary committee meets three to five times annually to investigate and consider complaints against members' breach of the COE provisions. This investigation and disciplinary committee is made up of FIA members headed by a member of the FIA council. This system of having a professional organization discipline itself raises many issues in regards to effective enforcement of the COE. How can the public be ensured that the committee is impartial in its actions and enforcement of the COE? In recent times, the public perception of the disciplinary arm of FIA has not been very positive. The government has posed serious questions and raised important issues related to the enforcement of the FIA COE. In the opening remarks at the 2011 annual FIA congress, the prime minister of Fiji stated quite clearly that there have been breaches of the COE by members of the most prominent accounting firms but the institutes disciplinary committee's action or in this case, non-action was obvious. This raises various questions as to the effectiveness of such an enforcement system (Bainimarama 2011).

In jurisdictions such as Australia, the entity responsible for the issuance and enforcement of ethical pronouncements is independent of the professional membership bodies and professional accountants. The Accounting Professional and Ethical Standards Board (APESB) set the ethical standards and enforce these standards on the members of Institute of Chartered Accountants (ICAA), CPA Australia, and Institute of

Public Accountants (IPAs). This ensures that the disciplinary process is independent and transparent.

In Fiji, there is a need to have an independent enforcement and disciplinary institution to issue and enforce the COE for accountants. If this is too costly then the existing arrangement needs to be reviewed and appropriate controls put in place to ensure that the process of issuing and enforcing the COEs is transparent and fair.

2.5.4 Stock exchange listing requirements

The only stock exchange operating in Fiji is the South Pacific Stock Exchange (SPSE) located in Suva. While there are only a handful of companies listed, the government has established the Capital Market Development Authority (CMDA) to encourage further listings. CMDA is now a part of the Reserve Bank of Fiji (RBF), which is Fiji's central bank.

The exchange has its own set of rules that apply to companies that are listed on the exchange. A number of these rules relate to financial reporting and disclosures in the annual reports. In addition, listed companies also have to comply with the corporate governance code issued by the CMDA.

2.6 Summary and Conclusions

The accounting profession in Fiji is self-regulated through the FIA. FIA develops and issues accounting standards and ethical standards for its members. FIA is also tasked with the enforcement of the ethical standards. The FIA council members are all accountants, with no representation of government or other stakeholders. By gaining control over the process of setting accounting and auditing standards and ethical guidelines, FIA has effectively captured the regulatory process and its oversight.

There is an urgent need for a regulatory overhaul. First, the FIA, which is a professional membership body for accountants, should not be tasked with the responsibility to develop regulations. The enforcement of regulations should also be moved to an independent board. Therefore, there is a need to develop an independent regulatory and enforcement body in Fiji. Should the regulatory process remain with FIA, there needs to be greater representation of relevant stakeholders on the council of FIA.

The current Companies Act is also an outdated legislation. First, it does not mandate the use of accounting standards by firms. Second, there are no provisions on auditor independence or corporate governance in general. The requirements on financial reporting are also archaic and insufficient. There is an urgent need for the Companies Act to be modernised and updated. In addition, there may be a need to enhance auditor independence through secondary legislations such as SOX in the U.S. or CLERP 9 in Australia.

CHAPTER 3: LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

3.1 Introduction

Independence is the cornerstone of the auditing profession (Leung et al. 2009, 79). It is a crucial element in the statutory reporting process and is a key element for adding value to audited financial statements (Mautz and Sharaf 1961). An auditor's opinion derives its value from the independence of the auditor from the management and directors of the entity that it audits. Lack of independence will render this opinion as suspect. In the recent past, the failure of corporate auditors to detect questionable accounting practices¹ has led to an increased interest in the independence of the auditors (Ghosh and Lustgarten 2006).

There are two aspects of auditor independence. One where the auditor is actually independent from the management of the client also referred to as independence in fact and second where the auditor is independent in appearance only. Independence in fact depends on the auditors' integrity, strength of character and objectivity (Leung et al. 2009, 79). It is impossible to observe the actual independence of an auditor. Independence in appearance is independence of auditor from the management in the eyes of stakeholders such as shareholders, regulators and the public. Independence in appearance is more important as it affects the users' decisions and perceptions (Schneider et al. 2006).

There are numerous threats to the independence of an auditor. These threats include self-review threat, self-interest threat, advocacy threat, familiarity threat, and intimidation threat. These threats and mitigating factors implemented by regulators and auditors are discussed in the next section.

¹ See for instance cases related to Enron, Parmalat, HIH Insurance, Satyam Computer Services Limited and the case of the National Bank of Fiji.

3.1.1 Threats to auditor independence

Self-interest threat to audit independence arises when the audit firm or a member of the audit team has to re-evaluate subject matter that is his or her own work to form a judgment. This threat arises in one of two ways, first, if the audit firm is also providing non-audit services to the audit client and second when a former employee of the audit client is a current member of the audit team.

Another threat to auditor independence arises when a member of the audit team gets to benefit from a financial interest in or conflict with, an audit client. This is referred to as self-interest threat. Various circumstances could create this threat including members of the audit team having significant financial interest in the client, dependence on audit fee from the client and having close business relationships with the client and potential of future employment with the client.

In addition, advocacy on behalf of the audit client is another threat to the auditors' independence. Circumstances such as dealing in or promoting the shares of an audit client and advocating on behalf of the client in litigations may give rise to advocacy threat (Leung et al. 2009). Close relationship between the auditor and the audit client or the directors and managers of the client may give rise to familiarity threat. Finally, intimidation threat arises when the auditor or a member of the audit team is threatened or perceived to be threatened by the audit client, which prevents them from acting objectively. In this thesis, the focus is on self-review and self-interest threat arising from the joint provision of audit and non-audit services to a client.

3.2 Non-audit services

Non-audit services collectively include all services provided to a client apart from financial statement audit. These other services may include bookkeeping, tax return preparation and advise, actuarial, valuation, internal auditing, and accounting information systems design and implementation. A number of terms are used to

describe non-audit services in the audit literature. These terms include management advisory services (MAS), business advisory and management consulting services or just consultancy services. Non-audit services is not limited to consulting but also includes compliance related services (such as taxation and accounting advice) and assurance related services (such as internal auditing).

Non-audit services can be purchased from the incumbent auditor or other providers of such services. It is the auditor provided non-audit services (APNAS) that this study is concerned with. Non-audit services purchased from other service providers other than the incumbent auditor do not pose any problems for auditor independence. Thus, from here on, whenever reference is made to non-audit services it is auditor provided non-audit services unless otherwise stated.

There are various studies, which report that non-audit services impair auditor independence (see for example Hay et al. 2006; Ye et al. 2011). On the other hand, many studies also report that the joint provision of audit and non-audit services provides various benefits. These studies report that the joint provision of audit and non-audit services enhances auditor's knowledge of the client, which leads to a more efficient and effective audit (see for example Simunic 1984; Beck et al. 1988; Knechel et al. 2012). A review of the studies conducted on non-audit services and its impact on auditor independence follows in the next section.

3.2.1 Non-audit services and auditor independence

A large body of research has examined the impact of non-audit services on the independence of the auditor across various markets and using various methodologies. The earliest studies on the issue date back three decades (Schneider et al. 2006). The most recent study on this issue by Ye et al. (2011) examines the association between relationship and economic bonds and the effect of this on auditor independence. The level of non-audit service fee is used as a proxy for economic bond while a set of variables (auditor tenure, audit partner tenure, long duration auditor-director

relationships, and alumni affiliation) is used to proxy for relationship bond. The study uses propensity to issue going-concern audit opinions as a proxy for auditor independence. The study was conducted using data from the Australian stock market for the year 2002. This enabled the authors to study the effects of relationship and economic bonds in a setting where there were no restrictions on the provision of non-audit services. The results show that audit firm tenure and alumni affiliation have an association with the purchase of non-audit services from the incumbent auditor and that this relationship is stronger for companies with low agency costs. The study also reveals that the auditors' propensity to issue going-concern audit opinion is negatively affected by long audit engagement partner tenure and the joint effect of auditor provided non-audit services and alumni affiliation. In summary, the study reveals that relationship bonds have an impact on purchase of non-audit services from the auditor and that jointly, relationship bonds with high levels of non-audit services lead to a higher chance of a clean audit opinion being issued when it is not warranted.

Earlier studies on non-audit services and its impact on auditor independence examine the issue from various perspectives. Studies involving users of financial statements investigate whether non-audit service affects independence in appearance while those involving auditors and corporate managers focus on the actual independence of the auditor. Past studies have looked at the perceptions of both users from the equity markets and the debt markets.

3.2.2 Perceptions of independence amongst equity market participants

Reckers and Stagliano (1981) examine the perceptions of financial analysts on the issue of auditor provided non-audit services. Their results show that financial analysts do not perceive independence to be impaired by non-audit services. In another study, Pany and Reckers (1983) investigate the perceptions of company board members regarding auditor provided non-audit services. Their results also show that generally, perceptions of independence are not negatively affected in the presence of non-audit services, however, company board members are less likely to approve the purchase of

information systems design and implementation services from the auditor and that they are also less likely to purchase high amounts of non-audit services from the auditor. In a more recent study, Jenkins and Krawczyk (2003) investigate the impact of different types of non-audit services on perceptions of independence using the public as subjects. Their results also show that the type of non-audit services does not affect negatively on perceptions of auditor independence.

In contrast, Mauldin (2003) provides evidence that the perception of independence is impaired amongst professional investors when the auditor provides non-audit services. This result is different from the three earlier studies; however, these differences could be a result of several factors. First, the studies by Reckers and Stagliano (1981) and Pany and Reckers (1983) were conducted in a different period compared to Mauldin (2003). Second, different participants are used in these studies. While Mauldin (2003) uses professional investors, Jenkins and Krawczyk (2003) use the public as participants. In summary, the differences in the period in which these studies are conducted and the differences in the participants used could be the cause of differences in the results.

While results on the impact of non-audit services on perceptions of auditor independence in the equity market are divergent, various studies provide consistent results that concerns of independence are mitigated when different personnel from the auditor's office provide the services (see for example Lowe and Pany 1995; Pany and Reckers 1984; Swanger and Chewning 2001).

Gaynor et al. (2005) examines the decisions of the board members to purchase audit and non-audit services from the same supplier. The results of this study indicate that board members were more likely to approve joint purchases where it was likely to lead to improvements in the quality of the services provided. This study had used board members, some of whom were also audit committee members. It was found that those who were audit committee members were not likely to approve joint purchases when non-audit fee disclosures were required publicly even if it led to improvements in audit quality. This indicates that audit committee members are more concerned with the

perceptions of auditor independence when audit and non-audit services are procured from the same supplier.

Generally, studies that have examined the perceptions of equity market participants regarding the impact of non-audit services on auditor independence provide mix results. There are certain studies that find that non-audit service impairs perceptions of auditor independence while other studies do not document such evidence.

3.2.2.1 Equity market reaction to non-audit services

Another stream of research on non-audit services and auditor independence focused on the market reaction to joint audit and non-audit purchases. Dopuch and King (1991) examine the impact of non-audit services on the client firm's asset prices. The results show that joint purchases do not influence asset prices, which means that non-audit services does not affect investors' perceptions of auditor independence. Church and Zhang's (2005) study also supports the conclusions reached by Dopuch and King (1991). In addition, Church and Zhang (2005) find that investor's willingness to sue the auditor (for a decline in the asset values) increases when non-audit services are provided. This implies that ex-ante, investors view provision of non-audit services as sufficient evidence of compromised auditor independence.

Frankel et al. (2002) using archival data document a negative relationship between non-audit service fees and the reaction of the market to the fee disclosures. The results are indicative of impaired auditor independence in appearance. Ashbaugh et al. (2003) investigate the impact of fee disclosures on abnormal returns. They use a within-firm design where the abnormal returns in the first year after fee disclosure became mandatory was compared with abnormal returns in the immediate prior period without fee disclosure. The results do not indicate any differences in the abnormal returns between the two years, which suggests that fee disclosures do not affect perceptions of auditor independence for investors. The results reported by Ashbaugh et al. (2003) contradict that reported by Frankel et al. (2002).

Krishnan et al. (2005) study the impact of non-audit service fee on firm's earnings response coefficient (ERC). The results indicate a negative relationship between non-audit service fees and ERC, which implies that non-audit services do impair auditor independence in appearance.

In general, the results from studies on market reactions to non-audit services are mixed. Church and Zhang (2005) and Krishnan et al. (2005) report that market participants perceive independence to be impaired when an auditor provides non-audit services. On the other hand, Dopuch and King (1991) and Ashbaugh et al. (2003) do not find evidence to support such a relationship.

3.2.2.2 Firm governance and non-audit purchase decisions

Corporate governance policies can have an impact on the purchase of non-audit services from the incumbent auditor. Glezen and Millar (1985) investigate whether the public disclosure of non-audit service fees required through the implementation of Accounting Series Release (ASR) No. 250 affected shareholder ratification of the auditors. The findings indicate that there was no significant difference between pre and post disclosure years in the shareholder approval of the auditor. Raghunandan (2003) also looks at shareholder ratification of the auditors in the presence of non-audit services and finds a weak association that is not economically significant.

Raghunandan and Rama (2003) examine the impact of audit committee composition on auditor ratification in the presence of non-audit services. The results indicate that in the presence of high amounts of non-audit services, shareholders are more likely to ratify the auditor when the audit committee is comprised entirely of independent directors. However, the results are not economically significant.

In another study, Mishra et al. (2005) examine the relationship between non-audit services and auditor approval ratios in the post-SOX era. They document an insignificant negative relationship between auditor approval ratios and the magnitude of

tax and other fees paid to the auditor. The results of this study are similar to that reported in earlier studies.

Abbott et al. (2003a) examine whether non-audit service purchases from the auditor is associated with audit committee composition and due diligence. The results indicate that when an audit committee is comprised entirely of independent directors and when the audit committee meets at least four times during the year, they minimize the purchases of non-audit services. Lee and Mande (2005) criticize Abbott et al. (2003a) for the use of non-audit service fee to audit fee ratio as a measure for non-audit services purchased. Lee and Mande (2005) use the natural log of non-audit service fee and find no significant relationship between non-audit services and audit committee due diligence.

Ghosh et al. (2006) examine the relationship between non-audit services and certain aspects of firm governance. They report that firm governance has a negative impact on non-audit service purchases. However, they also find a significant positive relationship between non-audit services and board activity. Generally, the result reported by Ghosh et al. (2006) is inconclusive.

The studies examining the impact of firm governance on non-audit service purchases provide mixed results. A number of the studies (see for instance Abbott et al. 2003a and Raghunandan and Rama 2003; Ghosh et al. 2006) provide weak evidence that governance structure affects the purchase of non-audit services. Other studies (see for example Glezen and Millar 1985 and Lee and Mande 2005) provide evidence that firm governance do not affect the purchase of non-audit services from the auditor.

3.2.3 Debt market participants, non-audit services and auditor independence

Various studies investigate whether non-audit services affect the perception of debt market participants regarding auditor independence. Lavin (1976) conducts a survey involving bank officers and financial analysts on their perceptions of auditor

independence given various scenarios including three scenarios where the auditor provided non-audit services. The first scenario where the auditor was acting as an intermediary between the client and a service bureau, the consensus between bank officers and financial analysts was that the auditor is independent. In the second case, the auditor provided bookkeeping services and prepared financial statements. There was a lack of consensus with the bank officers and financial analysts that the auditor is independent. In the third case, the auditors prepared payroll and performed bookkeeping services. While consensus amongst bank officers was that the auditor is independent, it was not the same for financial analysts. Pany and Reckers (1987) also conduct a study involving both financial analysts and bank loan officers regarding the effect of non-audit services on perceptions of auditor independence, however, they report mixed findings.

Other studies provide unambiguous results on the perceptions of the debt market participants on auditor provided non-audit services. Shockley (1981) reported that audit firms that provided non-audit services were at higher risk of losing independence according to bank loan officers and financial analysts. On the contrary, Pany and Reckers (1988) using loan officers as participants find that auditor provided non-audit services do not affect perceptions of independence. In a more recent study, Lowe et al. (1999), find that auditor provided non-audit services affects the perceptions of loan officers regarding independence resulting in lower number of loans being approved from a group of applicants with auditor provided internal auditing services. Thornton et al. (2004) also reports similar results.

Finally, McKinley et al. (1985) investigate whether auditor provided non-audit services affect the perception of bank officers regarding financial statement reliability and auditor independence. The case facts in the study explicitly stated that separate staff performs audit and non-audit services. The study shows that auditor provided non-audit services does not affect the decisions of the bank officers, hence, does not affect the perceptions of auditor independence and financial statement reliability. Lowe et al. (1999) also find that when separate personnel perform audit and non-audit services it

has a positive impact on the perceptions of lenders regarding the independence of the auditor.

Generally, there is more consensus amongst debt market participants in relation to the effects of auditor provided non-audit services on independence compared to equity market participants. The results of a large number of studies provide evidence that debt market participants, especially loan officers, view auditor provided non-audit services as a cause of reduced auditor independence.

3.2.4 Non-audit services and auditor decisions

A number of studies examine the impact of non-audit services on auditor's perception of their own independence. There are also a number of studies, which purport to examine the impact of non-audit services on the actual independence of the auditors.

3.2.4.1 Non-audit services and auditors perception of independence

The perspective of accountants may generally differ with respect to others on the impact of non-audit services on auditor independence. This difference is a result of many factors including their knowledge of the code of ethics and the standards of behaviour expected from auditors according to the code of ethics (Schneider et al. 2006). The code of ethics and, in certain jurisdictions additional regulations outlines the acceptable standards of behaviour for accountants and auditors. The accountants are also the only ones who can, ascertain the actual impact of non-audit services on their judgment and decision-making.

In a study involving professional accountants, Lavin (1976) examines the perceptions of auditors about auditor independence involving cases where auditor provided their clients non-audit services. The results in the survey indicate that accountants only had concerns about impaired independence when significant amounts of accounting and bookkeeping services were provided. In a similar study, Shockley (1981) using audit partners as participants found that the partners had greater concerns regarding

independence when auditor provided non-audit services but more serious concerns for the partners was auditor size and audit market competition.

Jenkins and Krawczyk (2003) examine the effect of different types of non-audit services on accountants and auditors. The results show that perceptions of the accountants and auditors were affected by provision of bookkeeping services and legal consulting services. Thornton et al. (2004) also finds similar results using accounting and auditing professionals. In another study, involving accountants and auditors from both large and small audit firms, Beaulieu and Reinstein (2006) test the effect of providing a summary of research findings on non-audit services to participants after their initial assessment and then asking the participants to re-evaluate their decisions. The results show that before reading the summaries accountants from small audit firms believed that non-audit services impair independence. The results after the summaries were provided indicate that the accountants from the small audit firms revised their beliefs more than their colleagues from the large audit firms.

The results in this area indicate that non-audit services affect the auditor's perception of their independence. However, the results are limited to certain types of non-audit services such as bookkeeping.

3.2.4.2 Non-audit services and actual independence

A small stream of studies examines the effect of auditor provided non-audit services on the actual independence of the auditors. These studies investigate the effect non-audit services have on auditor behaviour, audit effort and auditor judgment.

Davis et al. (1993) obtains access to the proprietary data from audit firms' working papers and finds a positive association between certain non-audit services and audit effort. Generally, the results suggest that additional effort is required for audit client who purchase non-audit services from their auditors, which is inconsistent with the hypothesis that non-audit services compromise independence.

Dopuch and King (1991) find that auditors reduce audit testing for clients who purchase non-audit services compared to audit clients who do not purchase non-audit services. The results may not be indicative of compromised independence as an alternative explanation for such behaviour is the existence of knowledge spillovers. However, research to date provides conflicting evidence on the existence of knowledge spillovers. The Davies et al. (1993) and Dopuch and King (1991) are the only two studies which examine the effect of non-audit services on audit effort. Given the limited number of studies, it may not be prudent to reach a conclusion on whether non-audit services affect audit effort. Another stream of research emerged in the 1990's. This stream of research examined the impact of auditor provided non-audit services on auditor judgment.

3.2.4.3 Non-audit services and auditor judgment

Davidson and Emby (1996) conduct an experiment in which participants (who were auditors) were asked to evaluate the clients internal control systems. The aim of this experiment was to find out if auditor's knowledge that the audit firm itself implemented the accounting information systems affects their evaluation of the internal control systems. The case facts characterized the accounting information systems being designed and implemented by the audit firm itself and for the control group the design and implementation being done by the clients' chief accountant. The results of the experiments main effect are insignificant.

In another study, Emby and Davidson (1998) test the effects of auditor provided non-audit services on the negotiating power of the auditors. The authors find that when the auditors are in a conflict with the client regarding disclosures, they are more likely to press on the client to comply when the auditor provides non-audit services of a specialized nature.

Asare et al. (2005) investigate whether audit client acceptance decisions are based on the ability of the audit firm to earn non-audit service fees in the future. The authors also try to find out that when high-risk clients are accepted, do the auditors compensate for higher risk by re-allocating staff to maintain audit quality. The results show that non-

audit services do not affect client acceptance decisions. The results also show that audit firms do re-allocate staff for high-risk clients to maintain audit quality.

In the three studies conducted to date on non-audit services and auditor judgment, none provides evidence that independence is impaired or affected in any way. However, it should be noted that experimental studies in this area are very problematic due to a number of reasons. One of the major reasons is that it is very difficult to re-create real world incentives in a lab. This may also be a reason for the low number of studies in this area. While experimental studies are limited, a number of studies have employed archival and analytical methods to examine the impact of non-audit services on auditor independence. These studies investigate the effect of non-audit services on auditor opinion.

Kornish and Levine (2004) analytically examine the effect of non-audit services on audit opinion. They find that in a single-period setting the provision of non-audit services does lead to the auditor issuing unqualified opinions for clients that do not warrant them, however, these results are not the same in a multi-period setting. They also find that when the audit committee has the powers to remove the auditor, the auditor has incentives to report truthfully over time.

Wines (1994) analyzed the audit reports of Australian companies for a period of 10 years from 1980 until 1989 and found that companies that received unqualified audit opinion also purchased more non-audit services. On the other hand, Barkess and Simnett (1994) find no relationship between non-audit services and audit opinion. Lennox (1999) investigates the association between non-audit services and audit qualifications using a sample of U.K. companies and reports a positive weakly significant relationship.

Sharma and Sidhu (2001) examine the impact of non-audit services on going concern audit opinion for financially distressed companies in Australian. Their results show that as the level of non-audit service increases the propensity to issue going-concern audit

opinion decreases. The results are indicative that the provision of non-audit services is likely to lead to an impairment of the auditor's independence. In contrast, DeFond et al. (2002) using a larger sample of U.S. companies find no significant relationship between non-audit services and the auditors propensity to issue going-concern audit opinion. Geiger and Rama (2003) report similar results to DeFond et al. (2002) using U.S. firms.

The studies presented here do not provide conclusive evidence that non-audit services lead to compromised auditor independence. Generally, different results are reported in different markets. In the next section, studies that examine the impact of non-audit services on management behaviour are reviewed.

3.2.5 Non-audit services and managers behaviour

The examination of non-audit services and its impact on the behaviour of corporate management would provide us with useful insights. In particular, the effect of non-audit services on the ability of management to engage in earnings management is potentially useful in evaluating the impact of non-audit services on auditor independence.

3.2.5.1 Earnings management and non-audit services

Frankel et al. (2002) provide empirical evidence that non-audit services are positively associated with earnings management. Ashbaugh et al. (2003) extend Frankel et al. (2002) by adjusting discretionary current accruals for firm performance and does not find any significant association between non-audit services and earnings management. Chung and Kallapur (2003) replicate the Frankel et al. (2002) study but control for various effects and find no association between non-audit services and earnings management. However, further studies conducted by Reynolds et al. (2004), Larcker and Richardson (2004), and Farag (2006) provide evidence that auditor provided non-audit services and earnings management are positively related.

Ferguson (2004) examines the relationship between non-audit services and two proxies for earnings management - financial statement restatement and discretionary accruals. A

sample of U.K. firms is used in the study. The findings in Ferguson (2004) support the proposition that non-audit services impair independence, as the relationship between three measures of auditor provided non-audit services and both measures of earnings management is significantly positive. Bajaj et al. (2003) employ the existence of class action lawsuits against a firm as proxy for earnings management. The result from their study shows that a significantly positive relationship exists between non-audit services and existence of class action lawsuits. However, their results are only valid for most extreme cases (cases with the biggest decline in stock prices).

Raghunandan et al. (2003) examine the effect of auditor provided non-audit services on financial statement restatement using sample of U.S. companies. The study uses unexpected fees rather than actual fees paid for audit and non-audit services. The results indicate that there were no significant differences in the unexpected fees for firms that restated their financial statements and firms that did not restate their financial statements. Kinney et al. (2004) also examine the effect of auditor provided non-audit services on restatements but distinguish the effect of different types of non-audit services. They do not find a significant positive relationship between two types of non-audit services (information systems design and internal audit) and restatements. However, they do find a positive relationship between fees for unspecified non-audit services and restatements, while a negative relationship was documented for tax related non-audit services and restatements.

In general, studies conducted on the impact of non-audit services on earnings management provide conflicting results. A number studies document that non-audit services lead to more earnings management, however, a similar number of studies provide evidence to the contrary.

The studies on auditor provided non-audit services and auditor independence in general are extensive. These studies also employ a range of methodologies and examine a wide range of factors and issues surrounding non-audit services and auditor independence. In

the next sub-section, an overview of prior research on non-audit services and auditor independence and current practices is provided.

3.2.6 Past research on non-audit services and current practices

The audit market has changed significantly over the last two decades. Various legislative changes have taken place including but not limited to the enactment of SOX in the U.S. and the enactment of CLERP 9 in Australia. While many of the significant changes in the audit market were the result of failures in the audit mechanism, prior audit research also contributed towards the changes in the audit market.

In 2002, the SOX banned the supply of many of the non-audit services by incumbent auditors. The regulators cited the auditors' economic dependence on non-audit services and the self-review and familiarity threats that arose from the joint supply of audit and non-audit services as reasons supporting the ban. Prior research on the impact of jointly supplied audit and non-audit services on auditors' independence provided mixed results. However, there were a number of studies that did provide evidence that perceptions of independence was affected by the supply of non-audit services (see for example Shockley 1981; Lowe et al. 1999; Mauldin 2003; Thornton et al. 2004). Whether regulators did consider these studies in drafting legislations on the supply of non-audit services would be an exciting area for future research.

It is also interesting to note that while a few studies did provide evidence of impaired independence in the presence of non-audit services; many more studies on this issue did not provide any such evidence. Many studies concluded that non-audit services do not affect the independence of the auditor. While empirical studies were concluding that non-audit services do not impair auditor independence, cases of actual corporate failure (for instance Enron) were providing evidence to the contrary. In the case of Enron, the auditors were receiving significant fees for non-audit work compared to audit services and this was cited as one of the causes of impaired independence of the Enron auditors.

While a number of studies provide empirical evidence on the impact that auditor provided non-audit services have on auditor independence, the issue of whether non-audit services affect auditor independence is far from being adequately resolved. Central to the issue of auditor provided non-audit services and its impact on the auditors' independence are the reasons why clients demand non-audit services from their auditors and why auditors supply their audit clients' non-audit services. Thus, the next section examines why clients purchase non-audit services from their auditors, followed by an examination of the supply of non-audit services by incumbent auditors, which is the focus of this thesis.

3.3 Demand for non-audit services

In assessing the impact of auditor provided non-audit services on auditor independence, it is important to understand the factors that determine the level of non-audit services purchased by clients. A number of studies model the demand for non-audit services utilizing an agency-based framework. In order to conduct such studies, non-audit service fees is an important variable and until recently, firms in most jurisdictions did not publicly disclose this. In the U.S. public disclosure of non-audit service fees was required for a brief period in the late 1970's and early 1980's and then from the year 2000 onwards. In Australia, non-audit service fees became publicly available from the year 2004 onwards. Thus, most early studies utilized data collected through surveys. The availability of fee data from the year 2000 resulted in an influx of studies on non-audit services.

3.3.1 Agency costs, client need, willingness to appoint and demand for non-audit services

Parkash and Venable (1993) pioneered the research on the factors that determine the amount of non-audit services purchased by audit clients from the incumbent auditor using a sample of U.S. firms. The authors examine the impact of agency costs on firms demand for non-audit services. Since, non-audit services have been associated with

impaired auditor independence by regulators and legislators; agency theory suggests that firms will have incentives to restrict purchases of non-audit services. They model non-audit service fees to a number of variables related to agency costs. It is also argued that only recurring non-audit services would impair independence. The variables included to proxy for agency costs are managerial ownership, outside investment concentration and leverage. Control variables included are net income and auditor industry specialization. Results show that the Big 8 auditors at that time audited more than 95% of the sample firms. The results also support the proposition that agency costs influence the purchase of non-audit services from the incumbent auditor. As potential agency costs increase, purchases of non-audit services decrease. However, this is only valid for recurring non-audit services. The study also shows that the higher the net income of a company the more non-audit services it purchases and that more non-audit services is procured from industry specialists auditors. One major limitation of this study is that it assumes that all firms are homogeneous and that only agency variables drive the demand for non-audit services.

Firth (1997) accommodates for cross-sectional differences amongst firms in the non-audit service model. This is done by extending the model to include a number of variables that explain client specific need for non-audit services in addition to the variables representing agency costs. The sample used in this study includes firms from the U.K. The results show that non-audit service purchases are significantly influenced by variables representing client specific need. The variables representing agency costs are also significant in explaining the purchase of non-audit services, which further support the results reported by Parkash and Venable (1993).

Houghton and Ikin (2001), further extend the non-audit service demand function using a sample of Australian firms. The authors argue that demand for non-audit services by clients are driven by an ex-ante need for such consultancy, auditors' ability to supply such services and the willingness of the audit client to appoint the incumbent auditor for non-audit work. The authors also argue that previous studies modelling demand for non-audit services fail to include in their models variables measuring the clients need

for such services and their willingness to appoint the auditor to provide such services. The variables indicating need for non-audit services include auditee size, auditee complexity, auditee restructuring, and appointment of a new chief executive officer (CEO), issue of new debt or stock and previous operating performance. The results indicate that the ex-ante need for non-audit services and auditees' willingness to appoint the auditor significantly explain the demand for non-audit services. The model in Houghton and Ikin (2001) also has higher explanatory power with an r-square of 0.584 compared to an r-square of around 0.250 to 0.350 reported in previous studies. The authors also explicitly identify auditor provided non-audit services as impairing auditor independence. They argue that a client may procure non-audit services from other suppliers that should not pose a threat to the auditor's independence. While prior studies intrinsically made this distinction, it was not explicitly stated.

3.3.2 Governance and demand for non-audit services

In the studies considered so far, the non-audit fee models included a number of firm specific and agency cost related variables. Abbott et al. (2003a) posit that an effective audit committee will also have an impact on purchases of non-audit services from the incumbent auditor. An effective audit committee is defined as an audit committee that meets at least four times during the year and is composed of independent directors entirely. Independent audit committees would demand an independent audit for two reasons. First, if there is a financial misstatement, the reputation of the audit committee members will be tarnished. Second, in case of financial misstatements, directors not part of the audit committee can subrogate their liability to audit committee members by asserting their reliance on them regarding the financial reporting function. Therefore, if purchase of non-audit services from the incumbent auditor is perceived to be impairing the independence of the external auditor, an independent and effective audit committee will have incentives to restrict the purchases.

Abbott et al. (2003a) employ the model developed by Firth (1997) but extend it by including a categorical variable for effective audit committee. Since Firth (1997) does

not include a number of variables that are significant in the non-audit fee model as identified by Houghton and Ikin (2001), the model in this study has a weak explanatory power. The r-square for the full sample model is 0.174 compared to an explanatory power of 0.584 in Houghton and Ikin (2001). Regardless of the limitations of this study, the results show support for the hypothesis that was presented.

Abbott et al. (2003b) examine the purchase of non-audit services by U.S. firms from their incumbent auditor using new data that became publicly available after the new disclosure rules were passed in the year 2000 by the Securities and Exchange Commission. Findings indicate that only 4% of firms do not purchase non-audit services from their incumbent auditor. Fifty one percent of firms pay non-audit fees that are higher than their audit fees. The results are important because at the time of the rule making, SEC had relied on data provided by firms. Much of the data was only for management consulting services, which is only a subset of total non-audit services. Abbott et al. (2003b) argue that SEC may have underestimated the frequency and magnitude of non-audit services. The authors also argue that the current disclosure regime should continue.

Ghosh et al. (2006) examine whether non-audit services influence auditor independence by examining the extent to which non-audit services fees are determined by economic efficiency or managerial opportunism variables. The authors argue that auditor independence will only be impaired if managerial opportunism is the reason for firms to purchase non-audit services from their auditor. If firms purchase non-audit services from their auditor because it is economically efficient then auditor independence should not be impaired. The proxy variables used for economic efficiency is auditor tenure and auditor specialization. The longer an auditor serves a client, the more knowledge is gained regarding the clients business, therefore, the auditor is a preferred choice for the procurement of non-audit services due to lower contracting and searching costs. An industry specialist auditor possesses greater expertise in the clients industry. Audit clients may purchase more non-audit services from the specialists to draw on this expertise. A significant positive relationship between non-audit services purchased and

the two proxy variables would indicate that economic efficiency reasons drive non-audit purchases.

On the other hand, variables that proxy for managerial opportunism are weak corporate governance, lower levels of CEO ownership, higher amounts of remuneration based on firm performance, and high leverage. If these variables are significant and positively related to non-audit purchases then it is likely that auditor independence may be impaired. Results reveal that demand for non-audit services are driven by economic efficiency variables as positive relationship was documented between non-audit services and both the proxies for economic efficiency. The coefficients for certain managerial opportunism variables were also in the positive direction and significant. However, collectively the managerial opportunism variables were not significant. This study makes an important contribution to the non-audit service and auditor independence debate. It utilizes the demand side approach or input based approach to examine the impact of non-audit services on auditor independence.

Habib and Islam (2007), provide evidence on the determinants of non-audit services using firms from Bangladesh. This is one of the few studies investigating non-audit services using dataset out of U.S., U.K., or Australia. The financial reporting and regulatory environment in Bangladesh is different from developed countries. One of the most important features of the audit environment in Bangladesh is the absence of the threat of litigation. The results of the study show that large firms, firms with high liquidity, firms having Big 4 as auditor, and firms with multinational operations purchased more non-audit services.

Dodd and Rainsbury (2007) provide an analysis of non-audit service fee for companies listed on the New Zealand Exchange (NZX). Over a six-year period starting from 2001 to 2006, the sample of companies faced a continuous increase in audit fees while the fees for non-audit services declined steadily over the period. The non-audit service fees seemed to have peaked in 2002 and then faced a steady decline since then. Out of the 30 sampled firms, seven firms had non-audit service fees in excess of audit fees for the

year 2006. One interesting aspect of the New Zealand (NZ) accounting and auditing environment is that there are no regulations curtailing the provision of non-audit services by incumbent auditors or requiring public disclosure of non-audit service fees. This can only mean that firms, as part of their own governance framework, restricted purchases of non-audit services from their auditors.

3.3.3 Impact of regulation on factors affecting demand for non-audit services

Abbott et al. (2011) seek to examine whether regulatory interventions such as requirements for firms to disclose non-audit service fees and restriction of certain non-audit services were successful as a response to improve auditor independence. The authors investigate the effect of these regulations through its impact on non-audit purchasing behaviour. The SEC in 2000 issued regulations that required public disclosure of non-audit service fees paid to the auditors. SEC had relied on the market to decide on the optimal amount of non-audit services that a firm could procure from the incumbent auditor. If the market feels that auditor independence is impaired by the provision of non-audit services, it will impose costs on firms that purchase non-audit services from their auditor. This will drive firms to limit purchases of non-audit services from their auditor. Thus, SEC had utilized demand side approach to curtailing auditor provided non-audit services.

In 2002, through the enactment of SOX, limitations were placed on the amount and type of non-audit services that could be procured from the incumbent auditor. The SOX also banned the supply of certain types of non-audit services. This approach relied on the supply side of the market for non-audit services. Abbott et al. (2011) demonstrate that the public disclosure rules were successful in curtailing non-audit services and that the imposition of SOX led to inefficiencies in the market. Omer et al. (2006) also reported similar results; however, his study was related to auditor provided tax services only.

A number of studies have examined the demand side of the market for non-audit services. Results from these studies offer interesting insights. Purchases of non-audit

services have been demonstrated to be driven by agency costs and firm specific variables that explain clients demand or need for non-audit services. Effective governance mechanisms limit purchases of non-audit services from the incumbent auditor. The most recent study on non-audit services by Abbott et al. (2011) sheds light on various regulatory efficacies.

While a number of studies have examined the demand side of the market for non-audit services and auditor independence, there is a lack of studies examining the supply side of the market. In the next section of this chapter, the supply side of the market for non-audit services is examined and a number of hypotheses on the reasons why auditors supply non-audit services to their audit clients are postulated.

3.4 Supply of non-audit services

While there are various studies that investigate the demand side of the market for non-audit services, few studies have ventured into the supply side. The supply side of the market for non-audit services is equally important. An audit firm may decide to accept or decline the request to provide non-audit services to its audit client and various factors may affect this decision.

In this thesis, the factors that may affect the supply of non-audit services by auditors are outlined and empirically tested. This is done through the development of a model for the supply side of the market for non-audit services.

In a service provider-client relationship, it is very important for the supplier of the services to be able to meet the needs of its clients. An audit firm purports to be a supplier of a wide range of services in addition to audit. Clients also have an increasing need for consultancy services. The effects of a globalised world and ever-increasing complexity of businesses drive the demand for a wide range of consultancy services. Thus, an auditor may supply non-audit services to its audit client because the client needs the services and prefers to procure these services from the auditor.

In addition to satisfying the client's needs, an audit firm may supply non-audit services to broaden its revenue base and to maintain a steady growth of the practice. This is even more important at a time when the saturation of the audit market means audit services may not contribute significantly to growth of the audit firm. On the same note, audit firms may low-ball audit fee to get their foot into the door. In the case where the audit has been a loss leader, the auditor may supply non-audit services to recover the losses.

The knowledge base that an audit firm possesses together with the technical capabilities may also influence the supply of non-audit services. The knowledge base and capabilities may be client specific, industry specific or general. If an audit firm does not possess the required expertise and the capability to provide the required non-audit services then it will not be able to supply these services to its audit clients. This is, as a result, an important determinant of non-audit service supply.

Three distinct reasons have been identified explaining why an auditor may supply non-audit services to its audit clients. The reason why an auditor supplies non-audit services is important, as it will have implications on the independence of the auditor. If the auditor supplies non-audit services to maintain a steady growth of the firm or to recover low-balled audit fee, this may have negative implications for the independence of the auditor. An audit firm that low-balled audit fee to get its foot into the door may expect to recover the low-balled audit fee from subsequent non-audit service engagements and this may lead the auditor to be more lenient towards the audit client just to maintain the auditor-client relationship. This reason for the supply of non-audit services is also opportunistic, as the auditor sees the provision of non-audit services as an opportunity to recover low-balled audit fees.

On the other hand, if the auditor supplies non-audit services to its audit clients because it possesses the requisite knowledge, capabilities, and technical competence then it is economically efficient. In many cases, an auditor may have better knowledge of the client's needs and business and is able to provide better services at lower costs

compared to other suppliers. This may be a result of knowledge spillovers. The size of the auditor may also influence the ability of the auditor to supply non-audit services. For example, a Big 4 auditor has access to more resources, is able to attract personnel that are more capable, and has the advantage of a global presence compared to a small local accounting firm and therefore, should be able to supply more non-audit services.

The regulators and legislators use the economic bonding (and low-balling) and self-review threats as the basis for the restrictions on non-audit services. The profession, on the other hand, argues that non-audit services does not impair their independence but enables them to perform an efficient and effective audit. As outlined in the preceding paragraphs, auditors may supply non-audit services for three distinct reasons. The supply of non-audit services to recover low-balled audit fees or to maintain growth of the practice supports the regulators and legislators arguments for legislation. The technical competence, capability and knowledge of the auditor as explanations for the supply of non-audit services support the professions position on the issue of joint audit and non-audit supply. Modelling the supply side of the market for non-audit services provides empirical evidence that will assist both the legislators and the profession understand each other's position, and most certainly bring some understanding to the debate. These factors and issues are explored in detail in the next subsection, which will lead on to the hypotheses.

3.4.1 Supply of non-audit services and audit fee low-balling

The arguments that lead to the first hypothesis are presented in this section. As outlined in the preceding section, auditors who low-ball audit fees are expected to have a higher propensity to supply non-audit services. Anecdotal evidence also suggests that firms lower the audit fee to accept clients to whom they could sell more lucrative non-audit services in the future. This is even more important at a time when the audit market is getting saturated. The public accounting firms see non-audit services as an important alternative source of revenue (Hillison and Kennelley 1988). Audit services are seen as a 'foot in the door', which will lead to lucrative non-audit service contracts. It is also

important to note that the magnitude of fee disclosed for non-audit services may not accurately indicate the importance of it to accounting firms. A more authentic but unobservable variable to study is the margins on audit and non-audit services.

In the next subsection, studies conducted to-date on audit fee low-balling is reviewed. The results of these studies are important because if audit fees are not low-balled then a study on the impact of low-balling on supply of non-audit services is not warranted at all.

3.4.1.1 Audit fee low-balling

As outlined in the preceding section, auditors may low-ball audit fees to get a foot in the door. It involves reducing fees below the cost of providing the audit services. This reduction in fees may lead to reduced audit work, which has the potential of impairing audit quality. Past research also explores the possibility of audit firms recovering low-balled audit fees through the provision of more lucrative non-audit services. This again leads to issues associated with auditor independence. If audit firms low-ball and recover the low-balled audit fee through the provision of non-audit services they may become too lenient towards the client for the fear of losing the client and with it the audit and more importantly the non-audit fees.

DeAngelo (1981) proposed that auditors are likely to earn quasi rents from audit clients in subsequent years. This quasi rent according to DeAngelo (1981) accrues to the auditor because of start-up costs associated with the appointment of a new auditor. Initial year audits usually require more work and this means that the costs for initial year audits are high. If the auditor does not charge a higher fee for the initial audit then the auditor may be viewing these additional costs as an investment and may be expecting future return on this investment. This is the reason why regulators see audit fee low-balling as problematic. If the auditor sees initial year discounts as an investment and expect a return on this in the future, then it is in the interest of the auditor to maintain the auditor-client relationship. In order to maintain this relationship an auditor may be lenient with the client and go along with the client when it comes to

negotiations on conflicts regarding financial statements. Dye (1991) provides analytical support for DeAngelo's (1981) original conclusion that low-balling will be observed in audit pricing. However, Dye (1991) also states that public disclosure of audit fees will lead to an elimination of low-balling of audit fees.

It is impossible to evaluate audit fee low-balling because actual audit cost is not public information. Thus, many prior studies use audit fee discounting by a new auditor as an indication that audit fee is low-balled. The literature on pricing of initial audits in U.S. capital markets suggest that initial audits are discounted (Francis and Simon 1987; Simon and Francis 1988; Turpen 1990; Ettredge and Greenberg 1990).

Francis and Simon (1987) document that initial audit engagements are priced significantly lower than continuing audit engagements. Another study conducted by Simon and Francis (1988) documents that audit fees are discounted in the initial year. Their results showed that price reductions of 24 percent for the initial year audit and 15 percent for the next two years existed in the U.S. audit market for the years 1979 to 1984. Turpen (1990) also reports initial year fee discounting using data from 1982 to 1984 for U.S. companies. Further analysis by Turpen (1990) reveals that fee discounting is prevalent for Big 4 as well as smaller-sized accounting firms.

Ettredge and Greenberg (1990) also find that the fees for initial audits on average are 25 percent lower compared to continuing audits. Their sample consisted of 389 firms for the period 1983 to 1987. Ettredge and Greenberg (1990) also provide evidence that fee discounting is significantly explained by a change in the auditors relative costs advantages, change in auditor class (Big 4 to non-Big 4), competition in bidding and change in auditor industry or situational expertise.

Schatzberg (1994) develops a theoretical model of audit fee low-balling and tests this model using an experimental design. The results show that audit fees were being low-balled. Sellers set the fee for year one audit below the year one costs. In some cases, excessive low-balling was also documented. In another study, Schatzberg and Sevcik

(1994) developed and tested a multi-period model for low-balling. The results reported in this study are similar to that reported in Schatzberg (1994). This study also provides evidence on auditor independence. The results show that sellers deviate from truthful reporting (in the presence of low-balling) when the future profits, from continuing as auditor is greater than the cost of misreporting. Elitzur and Falk (1996) provide further evidence on audit fee low-balling using an experimental market setting. The results are consistent with results reported by earlier experimental studies on low-balling.

Most of the studies conducted on audit fee low-balling use data gathered through surveys or use an experiment in a laboratory setting. Only a few studies use data that became available through the public disclosure requirement of the Accounting Series Release 250 from 1979 to 1981 in the U.S. Unlike the U.S., audit fee data was a required disclosure in Australia, as a result, a number of studies use publicly disclosed Australian data to test if audit fee low-balling occurs.

Butterworth and Houghton (1995) investigate audit pricing in the event of a change in auditor using Australian data. The study is motivated by the lack of empirical studies on audit fee low-balling in Australia. Results show that new auditors do not charge a significantly lower price than the incumbent auditors do. They also report that an auditor change leads to a higher amount of total fees paid to the auditor (both audit and non-audit fees included). These findings are inconsistent with what is reported by a number of U.S. based studies. One major limitation of this study is that data used relates only to firms from Western Australia.

Craswell and Francis (1999) suggest that initial year audit fee discounting may be due to the non-disclosure of audit fee publicly and suggest that after the requirement that audit fee be publicly disclose in the U.S. these initial year discounts should disappear. Craswell and Francis also provide evidence by using Australian data that audit fee discounting is non-existent in an environment where public disclosures of audit fee are mandatory. Thus, the results reported by Butterworth and Houghton (1995) and

Craswell and Francis (1999) provide support for Dye's (1991) proposition that fee discounting will not occur where audit fees are publicly disclosed.

On the other hand, Sankaraguruswamy and Whisenant (2005) and Ghosh and Lustgarten (2006) provide evidence that initial year fee discounting is still present in an environment where public disclosure of audit fee was required. These results are more consistent with the arguments advanced by DeAngelo (1981) that audit fee low-balling will occur in all market settings. Sankaraguruswamy and Whisenant (2005) provide further evidence, which shows that investors do not perceive earnings quality to be affected by initial audit discounting.

In a more recent study, Huang et al. (2009) examines if regulatory interventions into the audit market through SOX leads to a change in the initial audit low-balling. They hypothesize that audit fee low-balling will be less likely in the post-SOX environment compared to the pre-SOX period. Their results show that low-balling existed in the pre-SOX period but post-SOX, the low-balling disappeared and fee premiums were charged for initial audits. This means that post-SOX concerns of audit fee low-balling are not warranted but more recently, Orlik (2011) reports that small audit firms are concerned about audit fee low-balling by the Big 4 audit firms. In a number of cases, small audit firms claim to have missed audit tenders because the Big 4 firms undercut them on price. If this is the case then the issues with audit fee low-balling may still be a matter of concern for regulators and legislators in post-SOX environment.

In summary, the results on audit fee low-balling show that audit fees are low-balled in all market settings. In some cases, audit fees are low-balled for four years before fees return to normal levels. It is also important to note that audit fee low-balling studies have only been conducted in developed and highly efficient markets.

In the next subsection, the relationship between audit fee low-balling and non-audit services is reviewed. As alluded to earlier, non-audit services are considered more profitable than audit. Accounting firms also see non-audit services as an important

source of revenue especially at a time when the audit market is highly competitive and saturated.

3.4.1.2 Audit fee low-balling and non-audit services

Prior studies have examined the relation between non-audit services and audit pricing. Simunic's (1980) paper is a seminal work in this area. Simunic (1980) reports that firms purchasing non-audit services from the auditor, reported higher audit fees. They take the positive association between audit and non-audit services to be indicative of knowledge spillovers rather than low-balling. Simon (1985) also reports a positive relation between audit and non-audit fees. Palmrose (1986) examines the impact of different types of non-audit services on audit pricing. The results show that audit and non-audit fees are positively related. This result is the strongest for accounting related non-audit services but the relation also stands for non-accounting related non-audit services.

In another study, Ezzamel et al. (1996) examine the relation between audit and non-audit services using data from the U.K. They report that income earned by audit firms from non-audit services averaged 90% of the audit fees for the years 1992 and 1993. Their results also show that audit and non-audit fees are positively related. This result is consistent with the results of earlier studies on this issue. Firth (1997) also reports a positive relation between audit and non-audit fees using firms from Norway. Although, the results support earlier studies, Firth (1997) states that there is no plausible reason for the positive relation in the context of Norway.

Dunmore and Shao (2006) investigate whether audit fees are subsidized by profits from non-audit services using a sample of firms from New Zealand. They employed non-audit fees as a test variable in their audit fees model and found that cross subsidization was not significant.

On the contrary, Lai and Yim (2002) report that when the Big 4 audit firms supplied more non-audit services they were more likely to charge lower audit fees. This is the only study that provides evidence that non-audit services negatively affect audit pricing.

However, they also report that this does not affect auditor independence, as they do not find any relation between non-audit services and audit opinions.

In summary, studies examining the effect of non-audit services on audit pricing fail to find evidence that non-audit services lead to audit fee low-balling except Lai and Yim (2002). While these studies examined the effect of non-audit services on audit pricing, this thesis examines the effect of low-balled audit fees (and other factors) on the supply of non-audit services. It is postulated that, in the case where an audit firm has low-balled audit fees, the firms' propensity to supply non-audit services will be higher.

In a competitive market, an auditor bidding for the supply of audit work would factor in profits expected from non-audit work that are tied to the audit work. This is, in the sense that the incumbent auditor will have an advantage over other firms in getting the bid to provide such non-audit work.

The advantage that the auditor will have in bidding for the non-audit work is those arising from production economies where the incumbent auditor can slightly undercut its competitor and still capture much of the benefits. Furthermore, many clients simply call in their auditors to provide the non-audit work rather than putting it on tenders. It is postulated that incumbent auditors expect that they can capture economic rents from the provision of non-audit services if they can retain the audit engagement. Thus, the lower they bid for the audit work the higher their willingness to supply non-audit work to recover the low-balled audit fees. Given these arguments, the first hypothesis is framed in the alternative form as follows:

H1: Auditors that low-ball audit fees supply higher amounts of non-audit services.

3.4.2 Knowledge, technical capability and the supply of non-audit services

This study further argues that an auditor who has better expertise in the provision of non-audit services and is technically more competent will be willing to supply more non-audit services to its clients. Two measures of knowledge, expertise, and technical competence are identified in this thesis. These measures are auditor tenure and auditor size.

An auditor may gain better understanding of the clients systems and processes over time. Thus, the length of the auditor client relationship is a variable that can proxy for knowledge spillover. This enables the auditor to perform the non-audit services required much more effectively and efficiently.

The size of the auditor is another variable that can proxy for knowledge and technical capability of the auditor. Big 4 auditors have access to resources and training that non-Big 4 do not. They also have access to or have the ability to hire the best personnel and retain them compared to the non-Big 4 auditors. The Big 4 also has a global presence and the ability to transfer capability to regions and countries where certain capabilities may be lacking for example KPMG Fiji may be able to get its Australian counterparts to perform a forensic audit for a client in Fiji if they lack expertise in the area.

3.4.2.1 Auditor Tenure

Several studies provide evidence that the contracting costs decrease and knowledge spillovers increase as the duration of business relationships increase (Ghosh et al. 2006). Studies also show that communication and collaboration between parties to a contract improves as the tenure of their relationship increases (Levinthal and Fichman 1988; Asanuma 1989). Various other studies indicate that as the length of a strategic partnership/alliance increase, the contracting costs between the parties decrease, the trust between the parties' increases, and disputes become easier to resolve (Gulati and Singh 1998; Larson 1992; Ring and Van de Ven 1994).

The longer the auditor serves a client the more familiar the auditor becomes with the client and the greater the knowledge the auditor accumulates regarding the client. Therefore, the auditor becomes more efficient in serving the client as tenure increases. This particular factor works through knowledge spillovers. Knowledge spillover can be described as a situation where knowledge from one task can be transferred to another task. Knowledge spillovers increase as duration of a business relationship increases. Experimental Studies in auditing has found that auditor expertise increases with experience (Libby and Fredrick 1990; Ashton 1991). Furthermore, archival studies (see for example Johnson et al. 2002; Myers et al. 2003; Ghosh and Moon 2005) find that audit quality improves with lengthened auditor-client relationship. Myers et al. (2003) and Ghosh and Moon (2005) attribute this improvement to client specific expertise developed by the incumbent auditor. Such client specific expertise is likely to result in knowledge spillovers for non-audit services. Therefore, a positive association can be predicted between auditor tenure and supply of non-audit services. In this thesis, it is argued that the longer the tenure of the auditor, the more knowledge the auditor has in regards to the client, therefore, the higher the auditor's willingness to supply non-audit services to the client.

Gul et al. (2007) in a study using U.S. data find that non-audit services fees affect auditor independence when the auditor tenure is short. They hypothesize that threats to independence is greatest in the initials years of auditors tenure as the recently acquired quasi rents of incumbency makes auditors more vulnerable to client pressure or dismissal in earlier years of auditor client relationship. In addition, a new auditor is also not very familiar with the clients accounting system and firm characteristics (Gul et.al. 2007) which lead to lower quality audits. Myers et al. (2003) also documents lower quality audits when tenure of the auditor is short. The auditor receives incentives in terms of quasi rents or reputation building from an audit apart from fees. It is hypothesized that a longer serving auditor will be more inclined towards building reputation than earning quasi rents, which are a threat to independence, and reputation. These arguments are in a different direction from what has been advanced by regulators. Regulators have been promoting mandatory auditor rotation as a means of protecting

independence. Their arguments have been based on the notions of client familiarity and personal connection between auditor and client firms. Rotational tenure was seen as a mechanism to minimize these threats. The results reported by Gul et al. (2007) indicate that the effect of non-audit services fee on auditors' independence is contingent upon the auditors' tenure.

Geiger and Raghunandan (2002) in a response to calls for research on the relationship between audit tenure and audit failure investigate this relationship through an examination of prior audit reports for a sample of U.S. companies. The study posits that there is an association between auditor tenure and audit reporting for bankrupt firms. A multivariate analysis is used to test for this relationship. Results of the study indicate that there were more audit reporting failures in the earlier years of auditor – client relationship than when auditors served the client for longer periods. The results of this study debunk the notion that longer auditor tenure leads to impaired independence. This further supports the argument that longer auditor tenure, as a reason for the supply of non-audit services is economically efficient rather than opportunistic or harmful to auditor independence. These arguments lead to the development of the second hypothesis (in the alternative form):

H2a: The longer the auditor tenure the higher the amount of non-audit services supplied.

3.4.2.2 Auditor Type

The competence of the auditor to provide non-audit services is another factor that may explain the supply of non-audit services. The Big 4 auditors offer a broader scope of services than do the non-Big 4 audit firms (Ghosh et al. 2006). Furthermore, the Big 4 auditors have access to a broader scope of resources and this is available to the auditors of the firm. In addition, the Big 4 auditors have access to many technical workshops that the non-Big 4 may not have access to. The access to more resources, training and workshops would mean that Big 4 auditors are technically more competent in the provision of many accounting services including many of the non-audit services.

The Big 4 auditors also have a global presence and are easily able to transfer expertise on a global scale. The Big 4 also have the ability to hire and retain the best personnel. The global presence means that they are the preferred choice for multinational companies who may want the same firm to provide accounting auditing services over the world. The ability to hire and retain the best personnel also means that the Big 4 would be able to provide better services. In many cases, the Big 4 are also the preferred choice for banks, underwriters, auditor committees and financiers (Arnett and Danos 1979; Christodoulou 2010).

Research studies also indicate that the Big 4 auditors provide higher quality services (Francis 2004; Watkins et al. 2004). Simunic and Stein (1987) and Francis and Wilson (1988) argue that the Big 4 have invested heavily in building their brand reputation and as a result, provide higher quality services to protect the reputation. Prior research also indicates that the Big 4 invest heavily in technology compared to the non-Big 4 (Sirois and Simunic 2010). This investment also enables the Big 4 to provide better services.

In summary, the Big 4 accounting firms have access to greater resources, conduct more training for staff, are able to attract and retain qualified personnel, have a global presence, and have invested heavily in technology. The quality of services offered by the Big 4 is also superior compared to the non-Big 4. These factors indicate that the Big 4 auditors have a greater ability to supply a range of services. These arguments lead to the third hypothesis (in the alternative form):

H2b: The Big 4 auditors supply higher amounts of non-audit services.

3.4.3 Clients demand and supply of non-audit services

An audit client may demand non-audit services from its incumbent auditor. Therefore, an auditor may supply non-audit services to meet the needs of its audit client. Prior

literature outlines that a firm's need for non-audit services is driven by its size, complexity, performance, special situations, high growth, and high business risk.

The size of a firm is the most important factor affecting the need for non-audit services. The larger a firm is, the more the need for non-audit services. The complexity of the firm's operations also determines the need for non-audit services. The more complex a firm the more non-audit services it will need. Various variables can be used to proxy for complexity. Prior studies on firm complexity use the number of business segments and the number of subsidiaries to proxy for complexity.

Firms that are performing poorly need more non-audit services to improve their performance (see for example Parkash and Venable 1993; DeFond et al. 2002; Abbott et al. 2003a; Whisenant et al. 2003). On another note, firms performing poorly may not be able to afford non-audit services and hence, their demand for non-audit services may be limited.

The need for non-audit services rises if one off special situations arises for a firm. These special situations include the issue of new equity or the issue of new debt instruments, appointment of a new CEO, and so on. Prior studies such as Firth (1997) and Abbott et al. (2003a) provide evidence that special situations like the issue of new equity and debt securities leads to an increase in the need for non-audit services. Business risk facing a firm may also affect the need for non-audit services. The firms that face higher business risk and financial risk need more consulting services to minimize these risks.

Finally, firms facing high growth may need more non-audit services as they may be expanding into new markets, new products, and so on. The need for non-audit services in such a case will be driven by the need to explore such growth opportunities.

Given that the need for non-audit services may influence the supply of non-audit services, a range of variables that proxy firm size, complexity, special situations,

growth, risk, and performance are included in the non-audit services supply model. These variables are not the focus of this study. The focus of this study is on the opportunistic and efficiency factors in explaining the supply of non-audit services, therefore these variables are included in the model as controls.

3.5 Summary and Conclusions

In this chapter, literature on non-audit services and the effect of jointly providing non-audit and audit services to a client on the perceived independence of the auditor is reviewed. Drawing on prior literature, a model for the supply side of the market for non-audit services is developed. It is posited that auditors are willing to provide more non-audit services when audit fee is being low-balled with a view to recoup the low-balled audit fees. In addition, it is hypothesized that the Big 4 auditors supply more non-audit services due to their ability to provide non-audit services based on their expertise and resource availability. Further, longer tenured auditors are hypothesized to supply more non-audit services as they have gained client specific knowledge through the supply of audit services and that they are the preferred choice of the management. The next chapter presents the methodology and the model employed to test the hypotheses.

CHAPTER 4: RESEARCH DESIGN

4.1 Introduction

This chapter presents the research methods employed in this thesis. In addition, a model for the supply side of the market for non-audit services is developed and a discussion is provided on the dependent, independent, and control variables that are used. A detailed discussion on the sample used in this study and data collection follows. Finally, the statistical tests, robustness tests, and sensitivity analyses performed on the data are presented.

4.2 Modelling the supply of non-audit services

An empirical model on the supply of non-audit services is developed and tested in this thesis. It is postulated that the lower the audit fee, the higher the amount of non-audit services supplied by an auditor. Thus, the first variable included in the model is audit fee. A negative correlation is expected between audit and non-audit fees. The knowledge, technical expertise and the capabilities of an auditor will also drive the amount of non-audit services supplied. Auditor tenure and auditor type proxy for knowledge, technical expertise and capability in the model. The model also includes a number of variables to control clients need for non-audit services. As argued in the previous chapter, an auditor may supply non-audit services because the client demands these services. The final model is as follows:

$$\begin{aligned} \text{LNNASFEE} = & b_0 + b_1\text{LNAF} + b_2\text{AUDITOR_TENURE} + b_3\text{AUDITOR_TYPE} \\ & + b_4\text{LNNTA} + b_5\text{DA} + b_6\text{LIQ} + b_7\text{INVREC} + b_8\text{ROA} \\ & + b_9\text{SQSEG} + b_{10}\text{SQSUB} + b_{11}\text{FOROPS} + b_{12}\text{OPINION} + \varepsilon \end{aligned}$$

A discussion of the dependent variable, independent variables of interest and the control variables follow in the next three subsections.

4.2.1 Dependent variable

The dependent variable in the non-audit supply model is the amount of non-audit service supplied by the incumbent auditor to its audit client. This is measured by the dollar value of the auditor provided non-audit services for a particular financial year. Prior studies, for example, Ashbaugh et al. (2003), and Ferguson (2004) have used this measure in the non-audit service demand models.

Prior studies have also used other measures of non-audit services. Craswell (1999), Frankel et al. (2002) and Larcker and Richardson (2004) used the ratio of non-audit fees to total fees. Other studies have used non-audit fee to audit fee ratio (e.g. Firth 1997; Parkash and Venable 1993). Studies in the past have also scaled the non-audit fees by total revenue of the auditor (Chung and Kallapur 2003). The scaled measures of non-audit fees capture the economic importance of a client to the auditor. As a result, scaled measures are widely used in the audit literature.

As the interest is only in the magnitude of the non-audit services provided in this study, only the dollar value of the non-audit services is employed in the non-audit service supply model. The use of other measures of non-audit services would distort results. However, additional sensitivity analyses using the various alternative measures for non-audit services are performed.

4.2.2 Independent variables - variables of interest

4.2.2.1 Audit fees

The audit fee variable (LNAF), tests for the cross subsidization of audit and non-audit fees. The natural logarithm of total audit fees paid to the auditor for external audit services is used in the model. This data is disclosed in the annual reports of companies within the sample.

4.2.2.2 Auditor tenure

Audit firm tenure (AUDITOR_TENURE) is also examined in this study. There are two common proxies for auditor tenure used in prior studies. The first is a discrete variable to reflect a change in auditor in the current financial year and the second is the actual duration of the current auditor (Hay et al. 2006). The actual duration of the auditor tenure is used in the non-audit service supply model. As part of additional analyses, the alternative measure for auditor tenure is employed in the model and the results reported as part of the sensitivity analyses test results.

4.2.2.3 Auditor type

Auditor type (AUDITOR_TYPE) is a variable used to measure the technical competence of the auditor to provide non-audit services. The proxy for auditor type is the size of the auditor. The auditors are divided into Big 4 international audit firms and non-Big 4 as per prior studies. Auditor type is a categorical variable where one indicates a Big 4 auditor and zero indicates a non-Big 4 auditor. Information on auditor type is obtained from the annual reports of the companies in the sample.

4.2.3 Control variables

An important control variable in the model is a measure for client size. Client size is measured by the natural logarithm of total assets (LNTA). Prior studies into audit fee models indicate that client size accounts for 70 percent variation in audit fees (Simunic 1980; Hay et al 2006). Thus, this variable is included as a control in the non-audit fee model as larger client's demand more non-audit services while small clients demand less. It is expected that client size will have a significant positive impact on non-audit fees.

There are other control variables included in the model. The first set of these control variables include debt to equity ratio (DA), quick asset ratio (LIQ), the ratio of inventory and receivables value to total assets value (INVREC), the return on investment (ROA). These variables measure the risks associated with a particular client.

The second set of control variables employed in the model include the square root of the number of business segments (SQSEG), the square root of the number of subsidiaries (SQSUB), a discrete variable for foreign operations (FOROPS), and a discrete variable for the type of audit opinion (OPINION). These second set of control variables measure client complexity. A complex business has greater needs for consultancy and advice. Thus, it is expected that these variables will be positively associated with non-audit fees.

4.3 Sample and data

This thesis examines data related to firms listed on the South Pacific Stock Exchange in Fiji. Firms from Fiji are examined, as the financial reporting regulatory environment is very different from that of developed countries such as U.S., U.K., and Australia. First, the audit market in Fiji is largely self-regulated. Second and more closely related to this study is the absence of regulations restricting the supply of non-audit services by incumbent auditors. Countries such as the U.S. have from the year 2002 enacted legislations that restrict the amount and type of non-audit services that the incumbent auditor can provide to its audit clients. This gives us a unique setting in which to study the incentives behind the supply of non-audit services by incumbent auditors. Another motivation to use Fiji firms in this study is the fact that studies on non-audit services and its impact on auditor independence, audit quality and so on are mostly based on developed economies. While, still a small developing market, Fiji is also faced with financial reporting challenges. The audit market structure and regulation of the services provided by the profession in Fiji and the rest of the South Pacific Island Countries (SPICs) is of utmost importance to regulators, the profession, investors and the public. Despite an absence of regulation on the supply of non-audit services, it should be noted that there are guidelines on auditor independence (Fiji Institute of Accountants Code of Ethics) and local entities have to abide by corporate governance codes (CMDA Corporate Governance codes). A detailed discussion of the Fiji audit market is provided in Chapter 2.

There are 16 firms currently listed on SPSE. All the firms are used in this study. Years 1980 through to 2010 are examined. Since the data is both cross-sectional and time series, it forms a panel dataset. The panel is unbalanced. There are various advantages of using a panel dataset in this thesis. Using cross sectional data would not have allowed us to use regression analysis, as the data set would have been too small. Time series data for individual firms would also limit the external validity of the results. While panel datasets offer many benefits over time series or cross-sectional datasets, only minor statistical complications may arise (Wooldridge 2009). One complication is that the distribution of the population may be different in different time periods. This issue can be resolved by allowing the constant in the model to differ across time periods, which can easily be achieved by including year dummy variables (Wooldridge 2009).

The data for the firms are hand collected from the hard copy of the annual reports. The annual reports of the listed companies had been collected over time from the stock exchange and from the firms. Companies in Fiji were required to disclose all fees paid to the auditor in accordance with the Fiji Companies Act (1983).

Where necessary the data was transformed into its logarithmic form to remove skewness and kurtosis. A 90% winsorisation is conducted on the dataset so that it is more robust to outliers.

4.4 Statistical tests and sensitivity analyses

This study uses an Ordinary Least Squares (OLS) regression with the dependent variable being the level of non-audit services supplied. In order to use regression analysis a number of assumptions have to be satisfied. These assumptions are:

- The sample is representative of the population. If the sample is not representative of the population under study, sampling errors can affect the results of the regression analysis. In this study, the entire population of listed companies in Fiji is used in the regression analysis; therefore, sampling error is not a problem.

- The error is a random variable. This error refers to the error term or disturbance in the model, which represent factors other than the independent variables that affect the dependent variable. This error is also referred to as the residual or fitting error. This error term captures the effect of all other factors that may have an effect on non-audit fees apart from the variables specified in the non-audit supply model. In order for the regression to be valid, the error terms should be random.
- The errors are uncorrelated. This error also refers to the residual or fitting error. The use of ordinary least squares regression requires that the residuals be uncorrelated to each other. Correlation between the residuals would render the regressions results in valid. As stated later on in this thesis, statistical tests are conducted to ensure that the residuals are uncorrelated.
- The variance of the error is constant across observations. This again refers to the residual error or fitting error.
- The independent variables are measured with no error. Errors in this case refer to measurement error. There are four types of measurement errors. These four measurement errors can be categorised into two categories systematic measurement error and stochastic measurement error. Systematic measurement error consists of constant bias and variable bias. Stochastic measurement error consists of errors in independent variable and errors in dependent variable. OLS regressions are utilised with the assumption that independent variables are measured with no errors. If the independent variables are measured with error then the OLS regression will be biased. There are two types of independent variable errors, systematic variable bias and stochastic error in independent variable. Systematic variable bias is problematic for hypothesis testing but stochastic error in independent variable is not critical for hypothesis testing. This is because the presence of stochastic error in independent variable will always bias the coefficient towards zero. This will increase type I error. That is, it may lead to the incorrect rejection of a true null hypothesis. However, it acts against type II errors in hypothesis testing. The independent variables in this thesis are well established in prior studies in measuring what they purport to measure. As a result, measurement error in the independent variables is unlikely to affect the results of the regression analysis.

- The predictors are linearly independent, that is, multicollinearity is not a problem.

A number of analyses including correlation diagnostics are performed to ensure that these conditions are satisfied for the dataset.

A number of sensitivity tests are also performed. The model is re-run with various alternative measures for non-audit fees. The ratio of non-audit fees to total fees and the ratio of non-audit fees to audit fees are taken as alternative measures for non-audit services as done in prior studies (see for example Firth 1997; Parkash and Venable 1993; Whisenant et al. 2003; DeFond et al. 2002 and Craswell 1999). The alternative measure for auditor tenure is also employed in the non-audit supply model. The results of these additional analyses are presented as part of the sensitivity test results.

A robustness test is also performed on the model. The data does not include any banks but there are four financial institutions including an insurance company. Since these firms face different types of regulations and regulatory oversight, these firms are removed from the sample. The supply model is then re-run to ensure that the model is robust. The results of these tests are reported together as part of the robustness and sensitivity analyses results in the next chapter.

4.5 Summary and conclusions

In this chapter, the research methodology employed in the thesis is presented. In summary, a model for the supply of non-audit services is developed. The independent variable in this model is the amount of non-audit services supplied which is measured by the dollar value of non-audit fees in a particular financial year. The firms listed on SPSE are selected for this study, since the market size is very small all firms are utilized. The data forms an unbalanced panel dataset. Data was collected from published hard copy annual reports of the entities and entered manually into SPSS statistical package. OLS regression technique is used to test the hypotheses presented in this thesis and a number of sensitivity analyses are also performed on the dataset.

The next chapter presents the results of the statistical analyses performed followed by discussion of the reported results.

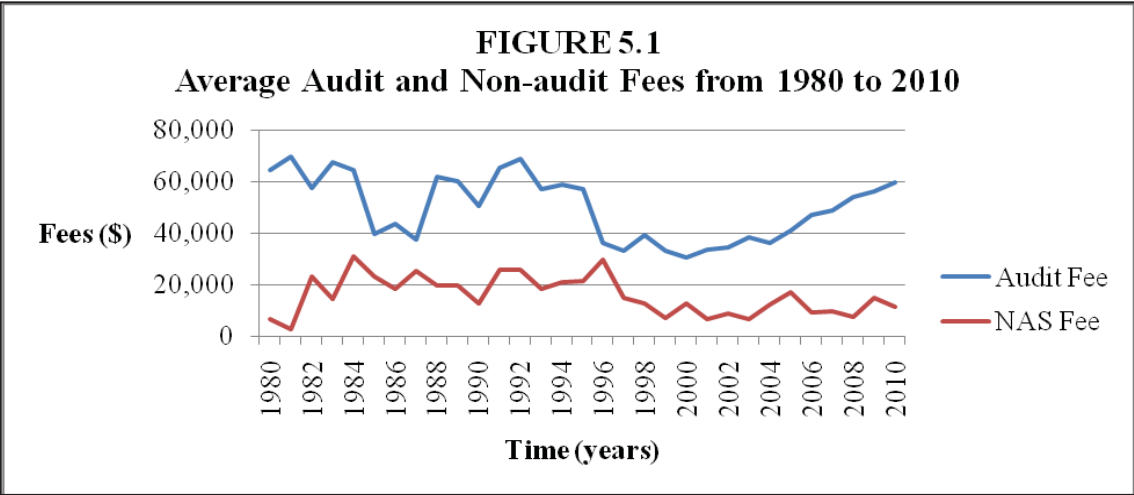
CHAPTER 5: SUPPLY OF NON-AUDIT SERVICES: RESULTS AND DISCUSSION

5.1 Introduction

This chapter presents the results of the analyses and statistical tests performed on the model for the supply of non-audit services. The results are followed by a discussion of the findings and the implications of the findings for the accounting profession, the regulators, the legislators, the audit clients, and the users of the financial reports.

5.2 Descriptive statistics

The descriptive statistics on the model and key variables are presented and discussed in this section. The first set of graphs and descriptive data present the trend in the audit and non-audit fees over time followed by the descriptive data on the overall sample. Figure 5.1 presents a graphical illustration of the average audit and non-audit fees from the year 1980 to 2010.



An interesting trend is visible in the graph presented in Figure 5.1. The general trend that appears in the graphs is a decline in average audit fees from 1980 to 1996 and an increasing trend in average non-audit fees from 1980 to 1996. This trend is then

reversed. The average audit fees begin to increase from 1996 to 2010 while the average non-audit fees begin to decline. This trend establishes that a negative relation exists between audit and non-audit fees.

The general trend in audit and non-audit fees is interesting because there appears to be no regulatory intervention in the Fiji audit market to cause such a reversal. However, in the early 1990s, the National Bank of Fiji went bankrupt. It was one of Fiji's largest corporate bankruptcies. The audit function was called into question at the time and even though no regulatory intervention took place in the market, the calls for concern regarding the audit function and the public attention on the issue may have caused the audit firms to take action. In order to manage their public image and perceptions of independence, audit firms may have responded by reducing the amount of non-audit services that they supplied their audit clients.

Table 5.1 presents the average audit and non-audit fees and the mean values of other key variables used in this study for every five-year interval in the sample period.

Year	Audit Fees (\$)	NAS Fees (\$)	Total Assets (\$)	Auditor Type	Auditor Tenure^a (Years)
1980	64,635	6,710	51,540,653	1.00	0.00
1985	40,000	23,533	19,719,360	1.00	5.50
1990	50,765	12,994	86,669,650	1.00	1.75
1995	57,281	21,647	103,347,561	1.00	1.75
2000	30,760	12,836	62,748,377	0.86	2.50
2005	41,313	17,233	73,104,691	0.81	6.31
2010	60,024	11,835	87,524,068	0.75	7.88

^a The earliest data available on the firms in the sample is from 1980, SPSE was established in 1979, and 3 firms initially listed on the exchange. Since 1980 is the first year, auditor tenure was measured from 1980 and is 0 for the first year.

The data presented in Table 5.1 confirms the trend visible in Figure 5.1. The statistics show a decline in average audit fees from 1980 to 1995. In 1980 the average audit fees was \$64,635 and in 1995, this had decreased to \$57,281. The statistics also show an increase in non-audit fees from 1980 to 1995. In 1980 the average non-audit fees was \$6,710 and in 1995, this had increased to \$21,647. In the year 2010 the average audit fees was \$60,024 and the average non-audit fees was \$11,835 depicting the reserving trend in the growth of the average audit and non-audit fees.

Table 5.1 also presents the statistics on auditor type and auditor tenure over the sample period. The Big 4 audit firms from 1980 to 1995 dominated the Fiji audit market. During this period, the Big 4 auditors audited all the listed firms. The Big 4 still dominate the audit market for listed companies; however, the market concentration is lower now as a national accounting firm also began auditing a small number of the listed companies. Thus, in 1980 the Big 4 audit market concentration was 100 percent while in 2010 it had dropped to 75 percent. The average auditor tenure in 2010 was 7.88 years. The auditor tenure is measured as the aggregate number of years the incumbent auditor served the client in its capacity as auditor. The average auditor tenure also increased over time. One of the reasons for this is that audit firm turnover is very low in Fiji. The turnover is low because there are no regulations for auditor rotation. In Table 5.1 and Figure 5.1, the trend over time for audit and non-audit fee was reviewed. The descriptive data for the overall sample is reviewed next. Table 5.2 presents statistics describing the dependent and independent variables in our non-audit supply model.

TABLE 5.2

Descriptive Statistics of Variables^a

Panel A: Dependent Variable	Overall Sample		
	N = 242		
Variable Description (Names)	Mean	Median	Std. Dev.
Non-audit fees (NASFEE) \$	13,320	5,000	20,919
Natural log of NASFEE (LNNASFEE)	6.06	8.52	4.59

TABLE 5.2 (Continued)**Panel B: Variables of Interest**

Variable Description (Names)	Mean	Median	Std. Dev.
Audit Fees (AF) \$	45,757	34,900	38169
Natural log of AF (LNAF)	10.22	10.46	1.17
Auditor Tenure (AUDITOR_TENURE) years	6.76	6.00	5.94
Auditor Type (AUDITOR_TYPE)	0.82	1.00	0.38

Panel C: Control and Other Variables

Variable Description (Names)	Mean	Median	Std. Dev.
Total assets (TA) \$	72,375,047	25,806,663	105,095,911
Natural log of TA (LNTA)	17.07	17.07	1.48
Debt to assets (DA)	0.42	0.41	0.28
Liquidity (LIQ)	4.60	1.27	41.12
Receivable and inventory intensity (INVREC)	0.30	0.27	0.22
Return on assets (ROA)	0.05	0.05	0.12
Square root of segments (SQSEG)	1.56	1.41	0.80
Square root of subsidiaries (SQSUB)	1.26	1.41	1.09
Foreign operations (FOROPS)	0.37	0.00	0.48
Audit opinion (OPINION)	0.04	0.00	0.19

^a the sample includes firms from the year 1980 through to 2010.

Dependent Variable:

NASFEE = fees billed (\$ actual) for auditor provided non-audit services.

LNNASFEE = the natural of NASFEE.

Variables of Interest:

AF = fees billed (\$ actual) for the audit of the annual financial statements.

LNAF = the natural log of AF.

AUDITOR_TENURE = the actual number of years the incumbent auditor served the client.

AUDITOR_TYPE = an indicator variable set to 1 if the auditor is a Big 4, 0 else.

TABLE 5.2 (Continued)

Control and Other Variables:

TA = the total assets of a firm measured in \$ thousands.

LNTA = the natural log of TA.

DA = the total debt to TA ratio.

LIQ = the ratio of current assets to current liabilities.

INVREC = the ratio of inventory plus receivables to TA

ROA = return on assets defined as earnings before interest and tax divided by TA

SQSEG = the square root of the number of business segments.

SQSUB = the square root of the number of subsidiaries.

FOROPS = an indicator variable set to 1 if the firm has operations in foreign countries, 0 else.

OPINION = an indicator variable set to 1 if the firm receives a qualified audit report, 0 else.

The descriptive statistics in Table 5.2 relate to the entire sample from 1980 to 2010 and all the firms in the sample. The average (median) amount of non-audit services supplied by incumbent auditors to their audit clients is \$13,320 (\$5,000). The average (median) audit fee is \$45,757 (\$34,900). On average incumbent auditors who jointly supplied audit and non-audit services to their clients earned non-audit fee equivalent to 29% of the audit fee. While for a number of firms in the sample, non-audit services purchased from the incumbent auditor was nil or lower than 29 percent of the audit fee, there are firms in the sample with non-audit fees more than 29 percent of the audit fees. In some cases, for some firms, in some years, the non-audit fees exceeded the audit fees.

In addition, using data presented in Table 5.1, the ratio of non-audit fees to audit fees in 1980 was 10.38 percent, in 1995, it was 37.80 percent and in 2010, it was 19.72 percent. This indicates that the percentage of revenue earned by auditors from non-audit services increased from the year 1980 to the mid 1990s, peaked in the mid 1990s and declined thereafter until 2010. The amount of non-audit services supplied by the incumbent auditors to their audit clients is still high by various measures. The SOX in the U.S. restricts the incumbent auditor from providing many types of non-audit services, and requires advance audit committee approval for the purchase of certain non-audit services that are not banned. In the case of Fiji, and the sample used in this study, an

analysis of the different types of non-audit services supplied by the auditor to its audit client cannot be performed because firms do not disclose information on the type of non-audit services supplied to them by the incumbent auditor.

The average auditor tenure is 6.76 years for the entire sample and as discussed earlier on in this chapter the average auditor tenure is 7.88 years for 2010. In Fiji, there are no mandatory requirements for auditor rotation; neither are there any regulatory requirements on audit partner rotation. The mean (median) debt to asset ratio for the entire sample is 0.42 (0.41), that is, on average every dollar of asset is financed with 42 cents of debt and 58 cents of equity. The mean (median) liquidity ratio for the entire sample is 4.60 (1.27). This indicates that for every dollar of current liabilities there is \$4.60 of current assets, meaning firms are highly liquid. Inventory and receivables make up 30 percent of the total assets of the sampled firms on average with a median value of 27 percent. The mean (median) return on assets is 5 percent (5 percent) for all the firms over the entire period from 1980 to 2010.

The mean (median) of the square root of the number of subsidiaries is 1.26 (1.41) and the mean (median) of the square root of the number of business segments is 1.56 (1.41). The mean value for foreign operations is 0.37 and for audit opinion, it is 0.04. This indicates that for 37 percent of the data points, the firms maintained operations in foreign countries. In relation to audit opinion, for four percent of the data points in the panel, the firms had not received an unqualified audit opinion.

The Pearson correlation coefficients are presented for the variables used in this study in Table 5.3. Multicollinearity may pose serious statistical issues if the Pearson correlation coefficient is greater than 0.95 for any two variables (Wooldridge 2009). None of the correlations is greater than 0.95, meaning multicollinearity does not pose problems in our analysis. The other statistic used to test for multicollinearity problems is the Variance-Inflation-Factors (VIFs). The VIFs in all our statistical tests for all variables were less than 10, which is the threshold beyond which multicollinearity problems may arise (Wooldridge 2009).

Table 5.3

Pearson Correlation Coefficients (n=242)

Variables	<u>LNNAS</u>	<u>LNAF</u>	<u>Auditor Type</u>	<u>LNTA</u>	<u>DA</u>	<u>LIQ</u>	<u>INVREC</u>	<u>ROA</u>	<u>SQSEG</u>	<u>SOSUB</u>	<u>FOROPS</u>	<u>Opinion</u>	
LNNAS	1.000												
LNAF	0.152*	1.000											
Auditor Type	-0.160*	0.099***	1.000										
Auditor Tenure	0.042	0.378*	0.197*	1.000									
LNTA	0.297*	0.826*	0.098***	0.271*	1.000								
DA	0.314*	0.246*	-0.044	0.102***	0.211*	1.000							
LIQ	-0.097	-0.182*	0.011	-0.075	-0.104***	-0.118**	1.000						
INVREC	0.056	0.162*	-0.157*	0.112**	-0.056	0.129**	-0.070	1.000					
ROA	0.021	0.019	0.007	0.097***	0.025	-0.209*	-0.039	0.134**	1.000				
SQSEG	0.092	0.433*	0.264*	0.396*	0.267*	0.137**	-0.048	0.417*	0.035	1.000			
SQSUB	0.161*	0.772*	0.315*	0.514*	0.669*	0.214*	-0.088***	0.109***	-0.017	0.630*	1.000		
FOROPS	-0.315*	0.422*	0.291*	0.033	0.275*	0.013	-0.052	0.207*	-0.108***	0.244*	0.322*	1.000	
OPINION	-0.007	0.177*	-0.080	0.082	0.290*	0.085***	-0.017	-0.151**	-0.272*	-0.139**	0.027	0.255*	1.000

*, **, *** significant at the 1%, 5% and 10% levels respectively.

See table 5.2 for variable definitions.

The audit fees and non-audit fees are highly correlated ($r = 0.152$). As expected the size of a firm measured by total assets is also highly correlated with non-audit fees ($r = 0.297$). The correlation coefficients also reveal a high correlation between auditor type and non-audit fees, debt to assets ratio and non-audit fees, square root of subsidiaries and non-audit fees and foreign operations and non-audit fees. Auditor tenure, liquidity, proportion of assets held in inventory and receivables, return on assets, square root of segments and audit opinion are all weakly correlated with non-audit fees.

In the next section of this chapter, the results of the regression analysis are presented followed by the results of the sensitivity analyses and robustness tests. The discussion section then follows.

5.3 Regression results

The regression results of the non-audit supply model are presented in Table 5.4. An OLS regression is employed to model the supply side of the market for non-audit services. The regression statistics reveal that our model fits the data well and is highly significant with an F-statistics of 10.761 ($p = 0.000$). The overall fit of model is good with an r-square of 32.7 percent. This indicates that 32.7 percent of changes in non-audit fees can be explained by the variables employed in the model. This is comparable with prior studies modelling non-audit fees.

The regression results indicate that there is a significant negative relationship between LNAF and LNNASFEE. The coefficient for LNAF is negative and significant at the 5 percent level of significance ($p = 0.028$). The result supports the hypothesis that auditors supply non-audit services because of audit fee low-balling.

The regression results also indicate that the coefficient for both AUDITOR_TENURE and AUDITOR_TYPE are negative and not significant ($p = 0.326$ and $p = 0.131$, respectively) leading to a rejection of Hypothesis 2a and 2b.

TABLE 5.4
Regression Results

Variable	Expected sign	Coefficient	t-value	p-value	VIFs
Constant		-11.528	-2.63	0.009**	
LNAF	-	-0.280	-2.211	0.028**	5.751
AUDITOR_TENURE	+	-0.100	-1.516	0.326	1.571
AUDITOR_TYPE	+	-0.063	-0.985	0.131	1.486
LNTA	+	0.532	4.921	0.000*	4.179
DA	+	0.224	3.897	0.000*	1.182
LIQ	+	-0.070	-1.294	0.197	1.159
INVREC	+	0.147	2.156	0.032**	1.660
ROA	+	0.005	0.078	0.938	1.242
SQSEG	+	0.058	0.728	0.468	2.277
SQSUB	+	0.120	1.063	0.289	4.526
FOROPS	+	-0.411	-5.913	0.000*	1.731
OPINION	+	0.005	0.077	0.938	1.500
Adjusted R ²	0.327				
F-Statistic	10.761				
Probability (F-Statistic)	0.000				

*, **, *** significant at the 1%, 5% and 10% levels respectively.
See table 5.2 for variable definitions.

The coefficient for LNTA is positive and significant ($p < 0.001$). This indicates that the size of the client is an important determinant of the amount of non-audit services supplied by the incumbent auditor to its audit client. The coefficient for DA is also positive and significant ($p < 0.001$). This indicates that the higher the debt to asset ratio the higher the amount of non-audit services supplied to the audit client. The coefficient

for INVREC is positive and significant as well ($p = 0.032$). In addition, the coefficient for FOROPS is negative and significant as well ($p < 0.001$).

The coefficient for LIQ is negative and not significant ($p = 0.197$). The coefficient for ROA is positive and not significant ($p = 0.938$). The coefficient for SQSEG is positive but not significant ($p = 0.468$). The coefficient for SQSUB is also positive but not significant ($p = 0.289$). The coefficient for OPINION is positive and not significant ($p = 0.938$).

5.3.1 Additional analyses

A number of additional analyses are performed on the non-audit supply model. These are sensitivity analysis and robustness tests. Sensitivity analyses are performed to ensure that the results reported are not sensitive to alternative measures of the independent or dependent variables. Robustness tests are performed to ensure that the non-audit services supply model is statistically robust.

5.3.1.1 Sensitivity analyses

Prior studies have employed alternative measures of non-audit services. In accordance with these prior studies, the non-audit to total fee ratio and non-audit to audit fee ratio are employed as independent variables in the model. The results remain qualitatively similar to that reported in our main analysis. This indicates that our results are not sensitive to different measures of the independent variable.

The alternative measure for auditor tenure is also employed in the model. In the main analysis, the actual number of years the current auditor served the client was used to measure auditor tenure. In the additional analysis, a categorical variable was included to proxy for auditor tenure. Our results in the additional analysis remain qualitatively similar to that reported in our main analysis.

5.3.1.2 Robustness tests

The sample used in this study includes a number of financial institutions including an insurance company. The banks and financial institutions follow additional financial reporting and corporate governance requirements and are regulated by the Reserve Bank of Fiji. These firms are dropped from the sample and the model is re-run. The results obtained after dropping these firms is similar to the results reported on the entire sample.

5.4 A discussion on the supply of non-audit services

The regression results support the hypothesis that auditors supply non-audit services to recover low-balled audit fees. This is evident by the negative relationship between audit and non-audit service fees. On the other hand, the hypothesis that non-audit services are supplied because auditors have the knowledge, capability and technical ability to supply such services, is not supported by the results. The coefficient for both the variables measuring an auditor's knowledge, capability and technical ability to supply non-audit services is negative and insignificant.

Since the results indicate that auditors supply non-audit services to their audit clients to recover low-balled audit fees, this provides regulators with empirical evidence to support regulations curtailing the supply of auditor provided non-audit services. In this case, the results have established that auditors supply non-audit services to audit clients for opportunistic reasons. This has the potential of impairing the auditors' independence - both perceived and actual independence. The result of being dependent of the revenue from non-audit services to recover losses from audit work means auditors may be intimidated to compromise their position on the audit of the financial statements. The other major issue with the joint supply of the audit and non-audit services is self-review threat. While certain services are more prone to self-review threat, the limitations in the disclosure of non-audit fees in Fiji prevent the analysis of the effect of different types of non-audit services.

As stated earlier, the coefficient on AUDITOR_TYPE is negative and insignificant. Auditor type was measured by a Big 4 and non-Big 4 categorical variable. The negative coefficient on this variable indicates that the Big 4 auditors actually supply less non-audit services to their audit clients. However, this relationship is insignificant as well. The hypothesis in this thesis was that due to their wide-ranging expertise and availability of personnel the Big 4 auditors would have the capacity and ability to supply more non-audit services compared to the non-Big 4 audit firms. One of the reasons for the opposite result in the regression analysis is that the Big 4 audit firms operate on an international scale and employ very high-risk management controls and standards. Regardless of the fact that in Fiji there are no restrictions on the joint supply of audit and non-audit services, Big 4 auditors may have internal quality control procedures adopted from their international practice that restricts that supply of non-audit services or different types of non-audit services to their audit clients. The Big 4 may also be concerned about their reputational capital and the perceptions that users may have on their independence from client management when they supply non-audit services.

The coefficient on the variable AUDITOR_TENURE is also negative indicating that the longer the tenure the lower the amount of non-audit services supplied. However, this relationship is also insignificant. The hypothesis presented in this thesis was that the longer the auditor tenure the higher the amount of non-audit services supplied as the auditor gains a better understanding on the firm and has more knowledge in serving the audit clients need for consultancy. This result could be partly explained by the fact that low-balling of audit fee usually occurs in the first few years of an audit. The audit fee is expected to return to normal levels in later years resulting in a lesser need to supply non-audit services to recover low-balled audit fees. This could mean that in early years of an audit, the auditor would be inclined to supply more non-audit services to recover low-balled audit fees. As the tenure gets longer and audit fees return to normal levels, there is a lesser need to recover any low-balled audit fees and in such cases, auditors

employ greater quality control and risk management guidelines. Since, the supply of non-audit services would create the perception of impaired independence the auditors may actually lower the amount supplied to the audit client.

The other reason for a negative relationship between auditor tenure and non-audit fees could be due to the natural decline in the supply of non-audit services over the years in our data set. The descriptive statistics reveal that average non-audit fee rose over the period 1980 to 1996 after which it started to decline steadily. The auditor tenure data, which is only available from 1980, is a continuous variable measuring the actual number of years an auditor has served its audit client as auditor. As tenure increases through the years, non-audit fee starts to decline from 1996 onwards, leading to negative relationship between the two variables.

The other variable that is statistically significant in the regression is LNTA. LNTA is the natural log of total assets that is employed to measure client size. It is hypothesized that the larger the size of the audit client, the more non-audit services it will demand, therefore, the higher the amount of non-audit services that will be supplied. As expected, the coefficient for LNTA is positive indicating that larger clients are supplied significantly higher amounts of non-audit services.

The debt to asset ratio employed as a control variable in the non-audit supply model returns a statistically significant positive coefficient. This means that, the higher the debt to assets ratio, the higher the supply of non-audit services to that particular audit client. Highly leveraged firms may need more consulting services to manage their position.

The LIQ variable has a negative coefficient, which is statistically insignificant. The negative coefficient indicates that there is an inverse relationship between the level of liquidity and the amount of non-audit services supplied to an audit client. Firms that have lower levels of liquidity may need more consulting services to improve their

liquidity positions. However, it is also contentious how firms with liquidity issues fund the purchases of more non-audit services.

The coefficient for INVREC is positive and significant. INVREC measures the proportion of assets held in the form of inventory and receivables. The positive relation means that firms with higher levels of inventory and receivables demand for and are supplied more non-audit services. Naturally, firms with high receivables may need consultancy advice on debt collection and management. Firms holding high amounts of inventory may also require more non-audit services related to valuation.

The regression results indicate that the coefficient for ROA is positive but not significant. The result means that the return on assets do not statistically affect the amount of non-audit services supplied to an audit client by incumbent auditors. The results are same for SQSEG and SQSUB with both having a positive coefficient but are both statistically insignificant. The square root of number of subsidiaries and the square root of the number of segments are expected to be positively correlated with the amount of non-audit services supplied. Firms with more subsidiaries and segments may have greater need for non-audit services. These firms are also considered more complex, which again drives the need for consultancy advice.

The variable FOROPS has a negative coefficient and is statistically significant in determining the value of non-audit services supplied. The variable FOROPS is a categorical variable, which is coded one if the firm has operations in foreign countries. The results mean that the incumbent auditors supply less non-audit services to firms with foreign operations. In our sample, six firms have operations in foreign countries. One of the firms is owned by an entity based in a foreign country. The rest have operations in other South Pacific island countries and in Australia or New Zealand.

The final variable in the model is OPINION. The coefficient for OPINION is positive but statistically insignificant. Only one firm in the sample had received an audit

opinion, which was not a clean audit opinion for a number of years due to going concern issues. A firm that receives a qualified audit opinion can be assumed to be in operational or financial problems and such firms would be higher consumers of non-audit services. They would need advice and consultancy services to turn around their operations. Thus, a positive relation is expected between audit opinion and non-audit services. The results show a positive relation but this relation is insignificant.

5.5 Summary and conclusions

The results of the analysis indicate that in Fiji, auditors supply non-audit services to recover low-balled audit fees. Auditors low-ball the audit fee in order to get their foot in the door and to more lucrative non-audit contracts. This has important implications for auditor independence. However, this study does not provide empirical evidence on the effect of non-audit services on auditor independence. The provision of non-audit services by incumbent auditors to their audit clients is currently not restricted in Fiji in any way as is the case in certain developed economies such as the U.S. A number of recommendations for regulatory reforms are provided in the next chapter.

CHAPTER 6: CONCLUSION AND POLICY RECOMMENDATIONS

6.1 Introduction

This chapter presents the conclusions formed from the empirical analyses performed on the supply side of the market for non-audit services. It also documents the policy implications emanating from this study. Finally, the limitations of this study and the directions for future research in the area of joint supply of audit and non-audit services are presented.

6.2 Auditor independence and non-audit services in Fiji

The results of the empirical analysis reveal that auditors supply non-audit services to recover low-balled audit fees. The relationship between audit and non-audit fees is negative and statistically significant in the regression analysis. The variables representing efficiency factors in the supply of non-audit services by incumbent auditors are insignificant.

The results provide empirical evidence that auditors in Fiji supply non-audit services for opportunistic reasons and this could lead to an impairment of their independence. If the auditor sees non-audit services as an opportunity to recover low-balled audit fees then they have an incentive and motivation to maintain the auditor-client relationship. In an effort to maintain this relationship, the auditor may go along with the client when there are conflicts between the two parties regarding financial statements and audit adjustments. This issue is even more problematic given the weak financial reporting regulatory environment and a weak legal environment in Fiji. The next few paragraphs provide an explanation on these issues.

The accounting profession in Fiji is self-regulated through FIA. FIA issues accounting and auditing standards along with the ethical pronouncements. FIA is also responsible

for the enforcement of these standards and ethical pronouncements. A major issue with this is that accountants are tasked to discipline other accountants. The issue is whether the accountants can do this impartially. In countries such as Australia, the enforcement of the ethical standards on accountants is the responsibility of an independent board not the professional membership bodies.

The current Companies Act is outdated. The Act does not mandate the application of accounting standards. The Companies Act also contains very few guidelines on auditor appointment, auditor dismissal and auditor independence issues in general. The Act lacks guidelines on corporate governance for companies such as the requirement for companies to have an audit committee. There are also no secondary legislations such as SOX or CLERP 9 to strengthen auditor independence in Fiji.

The legal environment in Fiji is weak compared to countries such as the U.S. In Fiji, for instance, shareholders of a company cannot file class action lawsuits. Class action lawsuits make it easier for shareholders to collectively file a case which otherwise would be impossible for them as individual shareholders given the costs associated with such actions.

The audit market is also concentrated with 75 percent of the listed companies being audited by the Big 4 audit firms. It is also interesting to note that to date no audit firm or auditor has been indicted in Fiji despite cases of audit failure.

Fiji has also seen its share of corporate bankruptcies. In the early 1990's the National Bank of Fiji went bankrupt with huge financial implications and losses. In the last decade, there have been many cases where the independence of auditors has been called into question, the very recent case being the FNPF write-downs on its investments.

The joint supply of audit and non-audit services is an issue in Fiji. The government also sees this as a threat to the independence of the auditors (see for example Bainimarama

2011). The lack of regulatory intervention coupled with a self-regulated accounting profession makes this issue even more contentious.

A number of recommendations together with the policy implications of our findings are presented in the next section. These recommendations would improve the market for audit services and the regulation of the accounting profession in Fiji.

6.3 Recommendations and policy implications

A number of recommendations emanate from the findings of this study. These recommendations also have implications for legislators and regulators. These recommendations would lead to improvements in the financial reporting regulatory framework in Fiji. These recommendations are:

1. The auditing profession and in general the accounting profession needs to be regulated by an independent authority. If this is too costly, more stakeholders should be taking an active role in the standard setting and enforcement processes by the Fiji Institute of Accountants. The enforcement of the ethical pronouncement should be the prerogative of an independent body to ensure impartial application of the pronouncement on the profession.
2. Regulations governing the appointment, dismissal, and general administration of auditors should be amended in the current Companies Act. The Act is in the process of being re-written. In this process, it is important to consider provisions relating to financial reporting and auditing seriously.
3. The accounting standards should be given legal mandate. This should be through the Companies Act.

4. Regulators and legislators need to consider the possibility of regulating the supply of non-audit services by incumbent auditors. The Fiji capital market is inactive; therefore, regulations that depend on the market to regulate the supply of non-audit services will not function efficiently.
5. The current Companies Act also fails to adequately provide for corporate governance guidelines. The current secondary requirements on corporate governance issued by the CMDA only apply to listed companies. It is recommended that relevant corporate governance principles be enshrined in the re-written Companies Act.

6.4 Limitations of this study and directions for future research

The following are limitations of this study and the results should be interpreted with these taken into consideration:

1. The sample used in this study only consists of companies listed on the SPSE. Thus, the non-audit supply model has only been tested using data from one jurisdiction – Fiji. This weakens the external validity of this study.
2. The sample of companies used in the study is small. The analysis is performed on data relating to 16 entities only. Regression analysis could not have been performed on a cross section of the data, as there would have been less than 30 data points. In order to alleviate the problem of a small sample size, a panel dataset is used in this study, giving 242 data points. A panel dataset consists of a time series for each cross sectional member in the dataset, thus combining cross sectional data with time series data.

3. There are a number of discrete variables used in this study. Auditor type, foreign operations and audit opinion are all measured using a discrete variable. This creates what is termed as the categorical variables problem in statistics.
4. It is possible that an important determinant of the supply of non-audit services has not been included in the model.

The following are avenues for future research in the area of joint audit and non-audit supply:

1. The model for the supply side of the market that is developed in this study should be combined with the model for the demand side of the market for non-audit services. A comprehensive model of the market for non-audit services will provide potentially useful insights on the effects of non-audit services on auditor independence. Such a model will also enhance our understanding of the economics of the market for non-audit services.
2. This model should be tested using data from different jurisdictions. Data from both developing countries and developed countries would provide useful insights into the supply of non-audit services. This will also improve the external validity of this study.
3. Future research also needs to extend this basic model for the supply side of the market for non-audit services. Any extension of this model will enhance our understanding of the determinants of the supply of non-audit services.
4. Another important area that future research should address is a survey of the auditors and legislators on the issue of joint supply of audit and non-audit services. While studies such as this provide some insights into the complex issues surrounding the supply of non-audit services, it is believed that better insights can

be gained if the views of both legislators and auditors are well documented. At the present moment, not much is known about the internal quality and risk management practices of auditing firms. The audit and non-audit pricing strategies of auditing firms are not well understood as well. While audit firms may not be so forth coming with information on their pricing, information on risk mitigation and personnel management in the case of joint supply of audit and non-audit services will surely be useful.

6.5 Summary and conclusions

This study provides empirical evidence on the determinants of the supply of non-audit services. The study reveals that auditors supply non-audit services to recover low-balled audit fees. This has implications for the independence of the auditors in Fiji. If auditors see non-audit services as a means of recovering low-balled audit fee, they will be inclined to maintain the auditor-client relationship. This may also mean that they would go along with the client and the demands of the client in order to maintain the relationship because if the auditor-client relationship breaks up, the ability to earn fees from non-audit work may also be lost, as most clients would engage their auditor to provide many of the non-audit services.

This issue is more problematic in a country such as Fiji with a weak financial reporting environment and a weak legal environment. The accounting standards are not legally mandated. The accountants are self-regulated. The current Companies Act is an archaic legislation. There have been cases of audit failure in the past in Fiji related to organisations such as the National Bank of Fiji.

Given these issues, this study calls for a number of regulatory reforms and interventions. It is recommended that the Companies Act in Fiji be revised to include modern guidelines on auditor independence, enforcement of accounting and auditing standards and corporate governance. It is also recommended that legislators in Fiji

consider some form of regulation on the supply of non-audit services by incumbent auditors. It is also recommended that an independent panel enforce ethical pronouncements in Fiji. This will ensure that instances of a breach of the rules would be dealt with impartially. These reforms would strengthen the financial reporting regulatory environment in Fiji and improve auditor independence.

In addition to the contributions to improving the financial reporting and auditing practices in Fiji this study contributes to the literature on non-audit services and auditor independence. It provides evidence that auditors supply non-audit services for opportunistic reasons, which may have an impact on the independence of the auditor. This thesis is also the first in examining the supply side of the market for non-audit services. While prior research has extensively modelled the demand side of the market for non-audit services, a supply side focus provides a complete model of the market for non-audit services. In future research, both the sides of the market should be examined together to provide better insights into the market for non-audit services.

In this thesis, the model for the supply side of the market was tested using data from a developing country - Fiji. In order to improve its external validity, this model can be tested using data from different jurisdictions. The non-audit supply model can also be enhanced in future studies to expand our understanding of the determinants of the supply of non-audit services.

Finally, another important area that future research should address is a survey of the auditors and legislators on the issue of joint supply of audit and non-audit services. While studies such as this provide some insights into the complex issues surrounding the supply of non-audit services, it is believed that better insights can be gained if the views of both legislators and auditors are well documented.

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