

AUDITOR INDEPENDENCE, AUDIT FEES LOW-BALLING, AND NON-AUDIT SERVICES: EVIDENCE FROM FIJI

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ABSTRACT

This study empirically examines 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. This model is then tested using audit and non-audit fee data from Fijian listed companies from the year 1980 to 2010. We find that audit fee low-balling leads to increased supply of non-audit services. This result is statistically significant. We also find that Big 4 auditors supply less non-audit services compared to non-Big 4 auditors. Finally, we find that the longer the auditor tenure the lower the supply of non-audit services. However, both these results are statistically insignificant. This leads to a conclusion that non-audit services are being supplied for opportunistic reasons as opposed to efficiency reasons. Our results are robust to a number of sensitivity checks.

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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, Ianniello, 2012, and Causholli et al. 2013). The accounting profession sees non-audit services as a growing source of revenue stream (Hillison and Kennelley, 1988, and 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 legislation restricting or banning auditors from supplying non-audit services to their audit clients, while in other jurisdictions legislation have been enacted that require corporations to publicly disclose the amount and type of non-audit services procured from the auditors. This study examines the supply side of the market for non-audit services.

The main objective is to investigate the reasons why an auditor supplies non-audit services to its audit clients. It is hypothesized that auditors supply non-audit services for three distinct reasons, first to respond to the needs of its clients. Audit clients may need a wide range of services such as taxation advice, accounting information system design and implementation, internal audit accounting advice in addition to financial statement audit. In many cases, the auditor is the preferred choice for the supply of these additional services as the client has easy access and the quality and efficiency of the supplier is already verified. This also reduces the searching and related costs for the client. Another reason an auditor may supply non-audit services to its audit client is that they have the requisite knowledge and technical capabilities. The auditor may also have a better understanding of the clients business and internal systems, which also helps in the provision of non-audit services. Knowledge spillover is the general term used to describe such knowledge transfers. Finally, it is hypothesized that an auditor may be willing to supply non-audit services to its audit clients to recover low-balled audit fees. Non-audit services are also more

lucrative in terms of profits margins compared to audit services (Hillison and Kennelley, 1988). Prior research provides evidence of audit fee low-balling (Francis and Simon, 1987, Simon and Francis, 1988, Turpen, 1990, and Ettredge and Greenberg, 1990). These studies, however, assume that auditors will only low-ball in their first year and that audit fees will normalize in subsequent periods. In this study, we predict that auditors will continue to low-ball after the initial year to maintain an audit client in subsequent periods and this will be cross subsidized by profits from non-audit work. Apart from low-balling where the auditor sets the fee below cost, we are also interested in all cases where audit fee is cross subsidized by non-audit profits. In fact, audit firms may not set the fee below cost but below normal levels of gross margins given the competitive pressures in the audit market. This practice is as problematic as the case where audit fee is set below cost.

The motivations to investigate the supply side of the market for non-audit services are numerous. Regulators and legislators on one hand have imposed legislation on the supply of non-audit services. In certain jurisdictions such as the U.S., certain types of non-audit services are banned from being supplied by the auditor while in other jurisdictions such as Australia, U.K. and the E.U. member countries public disclosure of non-audit fees are required and prior approvals have to be sought from audit committees for the procurement of non-audit services from the auditor. These regulations have been imposed amidst mixed results from studies conducted on the impact of non-audit services on auditor independence.

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. Thus, there is a lacuna in the literature on the supply side of the market for non-audit services. The supply side of the market for non-audit services is equally, if not more, important. The insights from the supply side of the market for non-audit services are potentially informative to regulators and legislators. This rest of this paper is organized as follows. The next section presents a brief review of relevant literature and formulates the empirical hypotheses. This is followed by the methodology section. The results are presented next followed by the conclusions section.

LITERATURE REVIEW

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 study, we outline the factors that may affect the supply of non-audit services by auditors and empirically test these factors by developing 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. In an economy that we operate in, clients 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.

We have identified three distinct reasons 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, auditor 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. Modeling 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 closure to the debate. We now explore these factors and issues in detail in the next subsection, which will lead on to the hypotheses.

Supply of Non-Audit Services and Audit Fee Low-Balling

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 being 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. 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 study examines the effect of low-balled audit fees (and other factors) on the supply of non-audit services. We postulate 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. We posit that the 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, we frame our first hypothesis in the alternative form:

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

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. We use two measures of knowledge, expertise, and technical competence. These measures include 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.

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, and 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 party's increases, and disputes become easier to resolve (Gulati and Singh, 1998, Larson, 1992, and Ring and Van de Ven, 1994). Knechel et al. (2012) provide evidence from the New Zealand audit market that the provision of non-audit services does lead to knowledge spillovers to audit services. This is evident as those firms with higher non-audit purchases have lower audit report lags. Angela and Hay (2013) provide further evidence in support of Knechel et al. (2012).

The longer the auditor serves a client the more familiar he/she becomes with the client and the greater the knowledge he/she 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, and Ashton, 1991). Furthermore, archival studies (see for example Johnson et al. 2002, Myers et al. 2003, and 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, we can predict a positive association between auditor tenure and supply of non-audit services. This study argues that the longer the tenure of the auditor the more knowledge he has in regards to the client and 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. 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.

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 (Aloke 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, and Christodoulou, 2010).

Research studies also indicate that the Big 4 auditors provide higher quality services (Francis, 2004, and 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. Given these arguments, we frame our third hypothesis in the alternative form:

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

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, and 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. A number of studies also investigate the influence of agency costs variables on the demand of non-audit services.

These studies employ a number of variables as proxy for the level of agency costs. Quick et al. (2013) provides evidence that agency costs do not influence the demand for non-audit services. 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, we include a range of variables that proxy firm size, complexity, special situations, growth, risk, and performance 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. The next section presents the methodology and the empirical model that will be employed to test the hypotheses.

DATA AND METHODOLOGY

Sample and Data

This study examines data related to firms listed on the South Pacific Stock Exchange (SPSE) 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 legislation 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.

There are 16 firms currently listed on SPSE. All the firms are used in this study. Years 1980 through to 2010 are examined. Annual data for the firms are utilized in this study. 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 study. 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). 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. 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.

Modeling the Supply of Non-Audit Services

An empirical model on the supply of non-audit services is developed and tested in this study. 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 section, an auditor may supply non-audit services because the client demands these services. The final model is as follows:

$$LNNASFEE = \beta_0 + \beta_1 LNAF + \beta_2 AUDITOR_TENURE + \beta_3 AUDITOR_TYPE + \beta_4 LNTA + \beta_5 DA + \beta_6 LIQ + \beta_7 INVREC + \beta_8 ROA + \beta_9 SQSEG + \beta_{10} SQSUB + \beta_{11} FOROPS + \beta_{12} OPINION + \epsilon \quad (1)$$

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 (LNNASFEE). 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, and 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.

Independent Variables - Variables of Interest

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. 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. 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.

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, and 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. Ordinary Least Squares (OLS) regression is utilized to test the model developed in this study. The use of OLS regression requires that the dataset satisfy a number of assumptions. Additional tests are conducted on the dataset to ensure that the assumptions of OLS regression are satisfied.

RESULTS AND DISCUSSION

The descriptive statistics in Table 1 relate to the entire sample from 1980 to 2010. 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 percent 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.

Table 1: Descriptive Statistics of Variables

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	
Panel B: Variables Of Interest		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		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	

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 BIG4, 0 else.

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.

This table presents the descriptive statistics on the variables utilized in the regression model for the entire sample. Panel A provides descriptive statistics for the dependent variable in the model. Panel B provides descriptive statistics on the independent variables of interest in this study and panel C provides descriptive statistics on the control variables.

The average auditor tenure is 6.76 years for the entire sample. 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 42 cents by debt financing and 58 cents by equity financing. 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 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% of the data points, the firms maintained operations in foreign countries. In relation to audit opinion, for 4% of the data points in the panel, firms had received anything other than an unqualified audit opinion or clean audit opinion. The Pearson correlation coefficients are presents for the variables used in this study in Table 2. Multicollinearity may pose statistical issues if the Pearson correlation coefficient is greater than 0.80 for any two variables (Wooldridge 2009). None of the correlations is greater than 0.80, 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). 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.

Table 2: Pearson Correlation Coefficients

VARIABLES	LNNAS	LNAF	AUDITOR TYPE	AUDITOR TENURE	LNTA	DA		
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*	0.800*	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**		
INVREC	0.056	0.162*	-0.157*	0.112**	-0.056	0.129**		
ROA	0.021	0.019	0.007	0.097***	0.025	-0.209*		
SQSEG	0.092	0.433*	0.264*	0.396*	0.267*	0.137**		
SQSUB	0.161*	0.772*	0.315*	0.514*	0.669*	0.214*		
FOROPS	-0.315*	0.422*	0.291*	0.033	0.275*	0.013		
OPINION	-0.007	0.177*	-0.080	0.082	0.290*	0.085***		
VARIABLES	LIQ	INVREC	ROA	SQSEG	SQSUB	FOROPS	OPINION	
LIQ	1.000							
INVREC	-0.070	1.000						
ROA	-0.039	0.134**	1.000					
SQSEG	-0.048	0.417*	0.035	1.000				
SQSUB	-0.088***	0.109***	-0.017	0.630*	1.000			
FOROPS	-0.052	0.207*	-0.108***	0.244*	0.322*	1.000		
OPINION	-0.017	-0.151**	-0.272*	-0.139**	0.027	0.255*	1.000	

1%, 5% and 10% levels respectively. see table 1 for variable definitions. This table presents the Pearson correlation coefficients for the variables used in the regression model. The correlation coefficients are presented for the entire sample.

Regression Results

We conducted a number of analyses before running the regression. First, we conducted analyses of the residuals and they indicate no problems of homoscedasticity and linearity. Tests of skewness and kurtosis indicated some problems about the normality of the residuals and therefore, data was transformed into its natural logarithmic form to get the best fit. The regression results of the non-audit supply model are

presented in Table 3. 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 modeling 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 our 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 3: Regression Results

Variable	Expected Sign	Coefficient	t-value	p-value
Constant		-11.528	-2.63	0.009**
LNAF	-	-0.280	-2.211	0.028**
AUDITOR_TENURE	+	-0.100	-1.516	0.326
AUDITOR_TYPE	+	-0.063	-0.985	0.131
LNTA	+	0.532	4.921	0.000*
DA	+	0.224	3.897	0.000*
LIQ	+	-0.070	-1.294	0.197
INVREC	+	0.147	2.156	0.032**
ROA	+	0.005	0.078	0.938
SQSEG	+	0.058	0.728	0.468
SQSUB	+	0.120	1.063	0.289
FOROPS	+	-0.411	-5.913	0.000*
OPINION	+	0.005	0.077	0.938
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 1 for variable definitions. This table presents the regression results for the equation: $LNNASFEE = \beta_0 + \beta_1 LNAF + \beta_2 AUDITOR_TENURE + \beta_3 AUDITOR_TYPE + \beta_4 LNTA + \beta_5 DA + \beta_6 LIQ + \beta_7 INVREC + \beta_8 ROA + \beta_9 SQSEG + \beta_{10} SQSUB + \beta_{11} FOROPS + \beta_{12} OPINION + \epsilon$. The results are shown for the entire sample.

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 NAS 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 ($p = 0.938$).

Discussion of the Results

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 us from analyzing 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 study 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 that we get in the regression analysis is that the Big 4 operates 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 study 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 year of an audit, the audit fee is expected to return to normal levels in later years resulting in less 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 fee. As the tenure gets longer and audit fees, return to normal levels, thus, there is less 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 actually lower the amount supplied to the audit client. The other reason for a negative relationship between 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 and therefore the more 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 not statistically significant. 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 with low levels of liquidity may require more non-audit services in terms of advice on ways of lowering liquidity, thus, a positive relation was expected. However, it is also contentious how firms with low levels of liquidity fund the purchase of more non-audit services. It is more likely that firms with liquidity problems may not be able to purchase high amounts of non-audit services even though they require more of such services. This may be a plausible explanation for the negative relation.

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 an audit opinion that is not clean or unqualified can be said 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. Our results show a positive relation but this relation is insignificant.

Further Analysis

Prior studies have employed alternative measures of non-audit services. In accordance with these prior studies, we employ non-audit to total fee ratio and non-audit to audit fee ratio as independent variables and find that 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. We also employ the alternative measure for auditor tenure. In our main analysis, we had included the actual number of years the current auditor served the client. In the additional analysis, we include a categorical variable to measure tenure. Our results in the additional analysis remain qualitatively similar to that reported in our main analysis.

SUMMARY AND CONCLUDING REMARKS

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. 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. 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 study is also the first in examining the supply side of the market for non-audit services. While prior research has extensively modeled 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.

There are a number of limitations of this study and the results should be interpreted with these taken into consideration. First, the sample used in this study only consists of companies listed on the SPSE. Second, the sample of companies used in the study is very small. The analysis is performed on data relating to 16 entities only. Third, 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. Finally, it is possible that an important determinant of the supply of non-audit services has not been included in the model. This study would not be complete without providing directions for future research. In this study, 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. 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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