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Audit Committee Independence and Expertise, Institutional Ownership, and Executive Compensation as Determinants of Audit fees in the Post-SOX Era
Audit Committee Independence and Expertise, Institutional Ownership, and Executive Compensation as Determinants of Audit fees in the Post-SOX Era

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Abstract

The objective of this dissertation is to examine the influence of firm-specific factors: audit committee independence and expertise, institutional ownership, and executive compensation, on audit fees in two different institutional settings in the post-Sarbanes Oxley Act (SOX) era. Prior studies on audit fee determinants examine the influence of these factors separately, from either the demand perspective or the supply perspective. These studies find inconsistent results. This dissertation examines the influence of all of these factors together considering both the demand and supply side perspectives.

The enhanced requirements for audit under SOX increase the audit risk of auditors. SOX imposes requirements for more thorough audit processes, and the oversight of auditors. These requirements make auditors more susceptible to legal penalties. However, SOX also emphasizes better corporate governance arrangements for firms. The quality of a corporate governance arrangement can serve as a signal for the auditors concerning the audit risk associated with a firm. The better the corporate governance a firm enjoys the lower would be the level of audit risk. This lessens the need for more thorough audits and, thereby, reduces the audit fee for the audited company.

This study uses the market perspective of price setting and regards audit fees as a price for audit services. While price could be regarded simply as an outcome of the quality of product demanded and supplied, there are many other factors that can influence price. Following the audit fee literature, this dissertation includes many determinants of audit fee including the firm-specific factors mentioned above. The study also looks at the influence of institutional settings on the price setting arrangements. In this regard, this study examines two different institutional settings, one a more regulated and highly litigious setting, and the other a less regulated and moderately litigious setting, to understand whether the variations in institutional settings influence the relation between the firm-specific variables and audit fees. The two institutional settings are those of the US and New
Zealand audit markets, where the US market is more regulated and litigious than the New Zealand market.

The study examines 4,490 US firm-years and 445 New Zealand firm-years from the years 2004 to 2008. The overall results suggest that the prevalence of independent audit committees and expertise has increased over the years in both countries. Therefore, no significant effect is found for the association between audit fees, and audit committee independence and audit committee expertise, except for the negative association for audit committee expertise in 2004. The result for institutional ownership is negative and significant for the US, whereas in New Zealand it is not significant. The likely reason for this difference is that financial institutions hold high levels of shares in US companies, whereas, in New Zealand the shareholdings of financial institutions is relatively small. Further analysis seems to suggest that, in New Zealand, corporate ownership in firms plays a stronger role in the audit fee setting process than institutional ownership.

For executive compensation, the two countries observe different incentive arrangements. The US firms have large incentive-based salaries and stock option schemes, whereas the New Zealand firms mainly have base salaries. For all of these methods of compensation, the results show that when compensation is high, audit fee is also high suggesting that auditors perceive higher audit risk when executive compensations under these schemes are high.

Further analyses of the above results reveal that the audit markets in both countries have supply-side market segmentation. Both countries seem to have three tiers of firms arising from the level of industry specialisation and the amount of audit fees charged. The level of audit fees varies between the tiers, and between the two countries for each tier. These variations suggest that the market for audit services has idiosyncrasies, and these idiosyncrasies vary across countries.

The data of the two countries are re-examined using a pooled data test. The sample of this test comprises firms of similar size from each country. The results show that because of their stronger regulatory oversight environment, on a scale
relative to total assets, US firms have lower audit fees than New Zealand firms when audit committee expertise and basic executive compensation are higher.

Taken as a whole, the findings of this dissertation provide strong support for the supply-side hypotheses of audit fee determination. The findings suggest that with better corporate governance arrangements in the post-SOX era, auditors perceive lower audit risk, which in turn, lowers audit fees. There is, however, some indication that strong regulations may have diminished the audit risk signalling capacity of audit committee independence and expertise.

**Key Terms:** Audit fees, audit market, supply-side hypotheses, audit committee independence and expertise, institutional ownership, executive compensation, BIG4 firms, and SOX.
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Table of Contents

Abstract....................................................................................................................... iii

Acknowledgements.................................................................................................. vi

Table of Contents...................................................................................................... vii

Chapter 1  Introduction ............................................................................................ 1
  1.1  Background and Objective............................................................................... 1
  1.2  Scope................................................................................................................... 6
  1.3  Structure............................................................................................................. 7

Chapter 2  Literature Review.................................................................................... 8
  2.1  The Audit Fee Literature.................................................................................. 9
  2.1.1  The Nature of Audit Services and Audit Fees......................................... 10
  2.1.2  Demand Features (Client Firm Characteristics)...................................... 12
    2.1.2.1  Size........................................................................................................... 12
    2.1.2.2  Complexity of Business Operations...................................................... 13
    2.1.2.3  Industry..................................................................................................... 14
    2.1.2.4  Operational Risks.................................................................................... 14
    2.1.2.5  Corporate Governance.......................................................................... 16
    2.1.2.6  Institutional Ownership.......................................................................... 19
    2.1.2.7  Executive Compensation...................................................................... 21
  2.1.3  Supply Features (Audit Firm Characteristics)............................................ 22
    2.1.3.1  Size........................................................................................................... 22
    2.1.3.2  Industry Specialisation.......................................................................... 23
    2.1.3.3  Corporate Governance.......................................................................... 24
    2.1.3.4  Institutional Ownership.......................................................................... 26
    2.1.3.5  Executive Compensation...................................................................... 27
  2.2  The Non-Audit Services Fee Literature........................................................... 28
  2.3  Institutional Influences.................................................................................... 31
  2.4  Underlying Reasons for Audit Fees Increase (Decrease)............................. 34
  2.5  Research Question.......................................................................................... 36
Chapter 3  Institutional Settings and the Influence on Audit Fees .......... 39

3.1  Background- US ................................................................. 40
3.2  Background-New Zealand .................................................. 44
3.3  Comparison – US and New Zealand Setting ......................... 49

Chapter 4  Hypotheses Development – US ........................................ 53

4.1  Audit Committee Independence and Expertise .......................... 53
4.2  Institutional Ownership .......................................................... 55
4.3  Executive Compensation ....................................................... 57
4.4  Summary ............................................................................... 59
4.5  The US Conceptual Schema .................................................. 60

Chapter 5  Hypotheses Development – New Zealand ....................... 62

5.1  Audit Committee Independence and Expertise .......................... 62
5.2  Institutional Ownership .......................................................... 63
5.3  Executive Compensation ....................................................... 64
5.4  Summary ............................................................................... 66
5.5  The New Zealand Conceptual Schema ..................................... 67

Chapter 6  Research Methodology .................................................... 69

6.1  US Sample Selection ............................................................. 69
6.2  New Zealand Sample Selection ............................................... 70
6.3  Empirical Model ................................................................. 72
6.3.1  OLS Regression .............................................................. 72
6.4  Variables ............................................................................... 75
6.4.1  Dependent Variable .......................................................... 75
6.4.2  Independent Variables ....................................................... 75
6.4.2.1  Audit Committee Independence and Expertise .................... 75
6.4.2.2  Institutional Ownership .................................................. 76
6.4.2.3  Executive Compensation ............................................... 76
6.4.3 Control Variables ....................................................................................................... 78
  6.4.3.1 Size .................................................................................................................. 78
  6.4.3.2 Complexity ........................................................................................................... 78
  6.4.3.3 Industry .............................................................................................................. 79
  6.4.3.4 Operational Risks ............................................................................................... 79
  6.4.3.5 Corporate Governance Variables ................................................................ 80
  6.4.3.6 Size of Audit Firm .............................................................................................. 80
  6.4.3.7 Industry Specialisation .................................................................................... 81
  6.4.3.8 Non-Audit Service Fees ................................................................................... 81
  6.5 Summary ................................................................................................................... 82

Chapter 7  US Results and Discussion ........................................................................ 83
  7.1 Results ................................................................................................................... 83
    7.1.1 Descriptive Statistics .......................................................................................... 83
      7.1.1.1 Audit Fees ........................................................................................................ 83
      7.1.1.2 Audit Fees by Auditors ................................................................................ 85
      7.1.1.3 Non-audit Service Fees ................................................................................ 86
      7.1.1.4 Audit Fees by Industries ............................................................................. 88
      7.1.1.5 Audit Fees and Non-audit Service fees by Firm Size ................................ 90
      7.1.1.6 Distribution by Audit Firms ........................................................................ 96
      7.1.1.7 Audit Committee Independence ................................................................ 100
      7.1.1.8 Institutional Ownership ............................................................................. 101
      7.1.1.9 Executive Compensation ......................................................................... 101
    7.1.2 Bivariate Correlations ....................................................................................... 103
    7.1.3 Multivariate Analyses ........................................................................................ 104
      7.1.3.1 Experimental Variables ............................................................................. 104
        7.1.3.1.1 Audit Committee Independence ...................................................... 104
        7.1.3.1.2 Institutional Ownership ................................................................. 105
        7.1.3.1.3 Executive Compensation ............................................................. 105
      7.1.3.2 Control Variables ......................................................................................... 106
      7.1.3.3 Multicollinearity ......................................................................................... 107
    7.1.4 Sensitivity Tests .................................................................................................. 107
List of Figures

Figure A Conceptual Schema-US in the Post-SOX Era ................................................ 61
Figure B Conceptual Schema - New Zealand Corporate Governance Principles ........ 68
Figure 1a: Overall Annual Audit Fees and Non-audit Service Fees ................................. 84
Figure 1b: Overall Annual Audit Fees-Scaled By Total Assets ...................................... 85
Figure 1c: Overall Annual Audit Fees of Audit Firms ...................................................... 85
Figure 1d: Annual Audit Fees Of Audit Firms-Scaled By Total Assets ........................... 86
Figure 1e: Annual Non-Audit Service Fees of Audit Firms ................................................ 87
Figure 1f: Annual Non-Audit Service Fees of Audit Firms-Scaled by Total Assets ....... 88
Figure 1g: Annual Audit Fees by Industries ....................................................................... 89
Figure 1h: Annual Audit Fees by Industries-Scaled by Total Assets .............................. 89
Figure 2a: Audit Fees-Super Firms ....................................................................................... 92
Figure 2b: Audit Fees-MidCap Firms ................................................................................... 92
Figure 2c: Audit Fees-SmallCap Firms ................................................................................ 93
Figure 2d: Non-Audit Service Fees-Super Firms ................................................................. 94
Figure 2e: Non-Audit Service Fees-MidCap Firms ............................................................. 94
Figure 2f: Non-Audit Service Fees-SmallCap Firms ........................................................... 95
Figure 3a: Annual Audit Engagements for Super Firms ................................................... 97
Figure 3b: Annual Audit Engagements for MidCap Firms ................................................. 97
Figure 3c: Annual Audit Engagements for SmallCap Firms ............................................. 98
Figure 3d: Audit Firms –Industry Leaders .......................................................................... 99
Figure 4: Annual Audit Committee Independence and Expertise Percentage ............... 101
Figure 5a: Annual CEOs Compensation ............................................................................ 102
Figure 5b: Annual CEOs Compensation-Scaled by Total Assets .................................... 103
Figure 6a: Annual Audit Fees .............................................................................................. 128
Figure 6b: Annual Audit Fees-Scaled by Total Assets ....................................................... 129
Figure 6c: Audit Fees – Industry-Wise ............................................................................... 130
Figure 6d: Audit Fees –Industry-Wise-Scaled by Total Assets ......................................... 130
Figure 7a: Audit Fees of Audit Firms ................................................................................ 132
Figure 7b: Audit Fees of Audit Firms-Scaled by Total Assets ........................................ 132
Figure 7c: Non-Audit Service Fees of Audit Firms ............................................................ 133
Figure 7d: Non-Audit Service Fees of Audit Firms-Scaled by Total Assets .................... 134
Figure 8a: Annual Audit Engagements of Audit Firms .................................................... 135
List of Tables and Exhibit

Table A Summary of Institutional Settings of the US and New Zealand.......................... 51
Table B Summary of Results of Tests of Hypotheses-US...................................................... 126
Table C Summary of Results of Tests of Hypotheses-NZ...................................................... 156
Table D Summary of Findings of the Two Countries.......................................................... 158
Table E Summary of Findings of the Control Variables ....................................................... 159
Table F Summary of Findings of this Thesis.............................................................................. 165
Table 1 Dependent and Treatment Variables Definitions.................................................... 186
Table 2 Panel A Data Selection-US........................................................................................ 187
Table 2 Panel B Distribution by Industry-US........................................................................... 188
Table 3 Panel A Descriptive Statistics -US............................................................................... 189
Table 3 Panel B Descriptive Statistics (Industry-Wise)-US....................................................... 192
Table 4 Panel A Average Audit Fees of Audit Firms (Annual)-US........................................ 193
Table 4 Panel B Average Audit Fees of Audit Firms (S&P type)-US...................................... 195
Table 4 Panel C Annual Audit Firm Distribution for S&P Super Firms-US........................... 197
Table 4 Panel D Annual Audit Firm Distribution for S&P MidCap Firms-US........................ 197
Table 4 Panel E Annual Audit Firm Distribution for S&P SmallCap Firms-US...................... 198
Table 4 Panel F Audit Firm Distribution (Industry-Wise)-US................................................ 199
Table 5 Descriptive Statistics – Dependent and Treatment Variables-US............................. 201
Table 6 Pearson (Spearman) Correlation Above (Below) Diagonal-US................................. 202
Table 7 OLS Regressions of Audit Fees Determinants-US.................................................... 203
Table 8 OLS Regressions of Audit Fees Determinants (Audit Firms)-US.............................. 204
Table 9 Dependent and Treatment Variables Definitions-NZ............................................... 206
Table 10 Panel A Summary of Sample Selection-NZ............................................................ 207
Table 10 Panel B Industry Distributions for the Sample-NZ.................................................. 208
Table 11 Panel A Descriptive Statistics (Per Auditee)-NZ....................................................... 209
Table 11 Panel B Descriptive Statistics- Per Auditee (Industry-Wise)-NZ............................. 213
Table 11 Panel C Audit Fees Charged by the Audit Firms (Annual)-NZ............................... 214
Table 11 Panel D Distribution of Auditees by Audit Firms -NZ.............................................. 216
Table 11 Panel E Distribution of Auditees by Audit Firms (Annual)-NZ................................. 216
Table 11 Panel F Audit Firm Distribution (Industry-Wise)-NZ.............................................. 217
Table 12 Descriptive Statistics – Dependent and Treatment Variables-NZ............................ 218
Table 13 Pearson (Spearman) Correlation Above (Below) Diagonal-NZ............................... 219
Abbreviations used in this thesis

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>AF</td>
<td>Audit Fees</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>AMEX</td>
<td>American Stock Exchange</td>
</tr>
<tr>
<td>BRC</td>
<td>Blue Ribbon Committee</td>
</tr>
<tr>
<td>CCMAU</td>
<td>Crown Company Monitoring Advisory Unit</td>
</tr>
<tr>
<td>CEO</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td>CFO</td>
<td>Chief Financial Officer</td>
</tr>
<tr>
<td>FMA</td>
<td>Financial Markets Authority</td>
</tr>
<tr>
<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
</tr>
<tr>
<td>GAO</td>
<td>Government Accountability Office</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IRD</td>
<td>The Inland Revenue Department</td>
</tr>
<tr>
<td>MED</td>
<td>The Ministry of Economic Development</td>
</tr>
<tr>
<td>NACD</td>
<td>National Association of Corporate Directors</td>
</tr>
<tr>
<td>NAF</td>
<td>Non-Audit Service Fees</td>
</tr>
<tr>
<td>NASDAQ</td>
<td>The National Association of Securities Dealers Automated Quotations</td>
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<tr>
<td>NEU</td>
<td>National Enforcement Unit</td>
</tr>
<tr>
<td>NYSE</td>
<td>New York Stock Exchange</td>
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<tr>
<td>NZAX</td>
<td>New Zealand Alternative Market</td>
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<tr>
<td>NZDX</td>
<td>New Zealand Debt Market</td>
</tr>
<tr>
<td>NZX</td>
<td>New Zealand Stock Market</td>
</tr>
<tr>
<td>OFCANZ</td>
<td>The Organised and Financial Crimes Agency of New Zealand</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PED</td>
<td>Price Elasticity of Demand</td>
</tr>
<tr>
<td>PES</td>
<td>Price Elasticity of Supply</td>
</tr>
<tr>
<td>POB</td>
<td>Public Oversight Board</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission-US</td>
</tr>
<tr>
<td>SECNZ</td>
<td>Securities and Exchange Commission New Zealand</td>
</tr>
<tr>
<td>SFO</td>
<td>The Serious Fraud Office</td>
</tr>
<tr>
<td>SOX</td>
<td>Sarbanes-Oxley Act, 2002</td>
</tr>
<tr>
<td>US GAAP</td>
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