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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  
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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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## Abbreviations used in this thesis

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