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NON AUDIT SERVICE PURCHASES BY FORMER AUDIT FIRM PARTNERS ON NEW ZEALAND AUDIT COMMITTEES

by

Madhukar Krishan Singh

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

School of Accounting and Finance
The Faculty of Business and Economics
The University of the South Pacific

September, 2015

Declaration

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Statement by Supervisors

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Dedication

I dedicate this thesis to my dad for his continuous guidance and support, without whom this milestone would have been impossible. He is responsible for all my achievements until today. I also dedicate this to my Uncle from Flagstaff, Pryenka, many friends and well-wishers who had inspired me to embark on this project.

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Abstract

Various researchers and regulators continuously highlight that if an auditor jointly provides non audit (NAS) and audit services to its client, then this inhibits independent audit of financial statements. Regulators argue that the lucrative NAS fees from the client can inhibit the auditor from disagreeing with the client. The fear of losing an important source of revenue can influence the auditor from exercising independent judgment over financial statement audits and issuing appropriate audit opinions. After Sarbanes-Oxley Act (SOX) banned NAS and increased liability for directors in United States (U.S.), many companies faced difficulties in hiring directors. Many recruiting agencies suggested that former audit firm partners would be suitable to serve as independent directors. However, critics again highlighted that former audit firm partners (FAPs) may have affiliations with the auditor of the company and may prevent the FAP from exercising independent judgment. The Securities and Exchanges Commission (SEC) called on the stock exchanges to strengthen corporate governance relating to FAP appointments. From 2004, legislations in the U.S. require FAPs to wait (cool-off) for a period of three years before serving as directors on audit committees.

Only two prior studies examine the presence of FAP on audit committees. Naiker and Sharma (2009) find that FAPs are negatively associated with internal control deficiencies. Naiker, Sharma and Sharma (2013) find that FAPs are negatively associated with NAS. Both these results, from the U.S. setting, indicate that the appointment of FAPs to audit committees is beneficial for the public company. The studies conclude that cooling-off rules are unwarranted.

This study examines FAPs and purchase of NAS in New Zealand (NZ), which presents a natural laboratory setting because (i) it is a low litigation environment, and there are no laws or mandatory regulations that (ii) restrict the provision of NAS to audit clients, and (iii) restrict the appointment of FAPs to audit committees. Moreover, this study is only the third to examine the presence of FAPs on audit committees. Other studies have examined FAP appointments at the executive level. The results of this study will complement the two pioneering studies (Naiker and Sharma 2009 and Naiker et al. 2013) about FAPs on audit committees.

This study hypothesises that audit committees with FAPs will purchase more NAS from the auditor in New Zealand. In the second hypothesis, the study posits that affiliated FAPs will purchase more NAS than unaffiliated FAPs in New Zealand. Unaffiliated FAPs are not expected to purchase more NAS because they do not share a past employment relationship with the current auditor. In contrast, affiliated FAPs have incentives to provide more business to their former employer, the current auditor of the client. Therefore, compared to affiliated FAPs, I expect unaffiliated FAPs to purchase fewer NAS from the auditor and focus more on maintaining possible threats to the independence of the auditor.

The study employs OLS regression to test the hypotheses. The sample consists 980 firm-year observations of companies listed on the NZ Stock Exchange between 2004 and 2013. The results indicate that FAPs purchase fewer NAS from the incumbent auditor, while results from the second regression indicate that affiliated FAPs purchase more NAS than unaffiliated FAPs. These results continue to hold following several sensitivity analyses.

Since affiliated FAPs are positively associated with NAS, it can either imply that the presence of affiliated FAP creates auditor independence problems or creates knowledge spillover benefits. To test these possibilities, further analyses are conducted using Tanyi, Raghunandan and Barua (2010)'s and Knechel and Sharma (2012)'s audit lag model, and Sharma and Kuang (2014)'s aggressive earnings management model. The results indicate that affiliated FAPs who purchase high NAS are associated with longer audit lags. The results on earnings management indicate that affiliated FAPs, who purchase higher amounts of NAS, are positively associated with aggressive earnings management.

This study makes several contributions to practice and literature. Naiker and Sharma (2009) mention that there is no prior study, which specifically examines FAPs on audit committees. Following this study, Naiker et al. (2013) examine FAPs on audit committees and NAS in U.S. The current study becomes only the third study to examine FAPs on audit committees and only the second study to examine the presence of FAP on the audit committee in the context of NAS, which is a focal point for regulatory concerns world-wide regarding auditor independence.

Most importantly, this is the first study to examine the presence of FAPs on audit committees in a setting where regulations do not restrict NAS purchases and FAP appointments. Naiker and Sharma (2009) and Naiker et al. (2013) question the cooling-off rule for FAP appointments and conclude that it is unwarranted. However, the empirical investigation of FAPs in a natural setting such as NZ suggests that unregulated appointments of FAPs to audit committees may not be beneficial when it comes to NAS purchases and auditor independence. The results from this NZ study imply that the benefits of having FAPs on audit committee are different from the U.S. setting because of NZ's less litigious regulatory environment. The findings raise implications for policy makers in NZ. Since affiliated FAPs pose greater threats to auditor independence and audit quality, NZ policy makers may want to consider regulating appointment of FAPs (and other former audit firm employees) from serving as independent directors on audit committees. Policy makers may also want to consider implementing cooling off rules but any such cooling-off period should be carefully determined, rather than some random period such as three years in the U.S. A third implication is that policy makers may want to consider limiting NAS auditors can jointly provide to their audit clients but ensure that restrictions do not stifle audit quality.

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List of Abbreviations

AFAP	Affiliated Former Audit Partner
BRC	Blue Ribbon Commission
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CLERP	Corporate Law Economic Reform Act
EU	European Union
FAP	Former Audit Partner
FEERATIO	Ratio of non audit fee to total fees paid to the auditor
FMA	Financial Markets Authority
FOROPS	Foreign Operations
FRC	Financial Reporting Council
FRSB	Financial Standards Reporting Board
FTC	Federal Trade Commission
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IAF	Internal Audit Function
IASC	International Accounting Standards Committee
ICAEW	Institute of Chartered Accountants in England and Wales
ICANZ	Chartered Accountants Australia and New Zealand
IFRS	International Financial Reporting Standards
LNAF	Natural Logarithm of Audit Fees
LNNAF	Natural Logarithm of Non audit Fees
NAS	Non audit Services
NASDAQ	National Association of Securities Dealers Automated Quotations
NYSE	New York Stock Exchange
NZ	New Zealand
NZICA	New Zealand Institute of Chartered Accountants
NZSA	New Zealand Society of Accountants
NZX	New Zealand Stock Exchange
OLS	Ordinary Least Squares
PCAOB	Public Company Accounting Oversight Board
PPB	Professional Practices Board

PwC	PricewaterhouseCoopers
SEC	Securities and Exchanges Commission
SOX	Sarbanes-Oxley Act
UFAP	Unaffiliated Former Audit Partner
UK	United Kingdom
US	United States
USP	The University of the South Pacific
VIF	Variance Inflation Indicator
XRB	External Reporting Board

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CHAPTER 1: INTRODUCTION TO THE THESIS

1.1 Introduction

This study investigates how the presence of former audit firm partners (FAPs) on New Zealand audit committees is related to the purchase of non audit services (NAS) from the auditor. The study also examines how two types of FAPs - affiliated and unaffiliated former audit firm partners – are related to NAS. Affiliated former audit firm partners (AFAP) on audit committees are directors, who have any length of past employment relationship with the current auditor of the company. Unaffiliated former audit firm partners (UFAP) have no such ties and are from other audit firms.

Prior researchers and regulators have mostly concluded that purchase of NAS from the external auditor impairs the independence of the financial statement audit process. In the U.S., the Sarbanes-Oxley Act (SOX) bans the provision of most forms of NAS by the auditor of the company. SOX also mentions that an auditor's independence is likely to be impaired if permissible and preapproved NAS fees are at least five percent of total fees received from the client. Other countries such as Australia and the European Union have followed the U.S. to enact somewhat similar legislations to regulate auditors and the provision of NAS.

Although the Corporate Law Economic Reform Program 9 (CLERP 9) does not ban NAS in Australia, it requires audit committees from July 2004 to preapprove all NAS purchases from the auditor. Similar requirements have recently been approved by the European Parliament and are expected to affect all of its 28 member states from 2016. Apart from requiring preapproval, the European Parliament has also agreed to ban certain types of NAS. The restriction applies to; *inter alia*, tax, compliance, tax advice, corporate finance and valuation types of NAS. An audit firm is eligible to provide financial statement audit services if it has not provided any NAS during the immediate past year.

In addition, the European Parliament has decided to cap permissible NAS at 70 per cent of the statutory audit fee. This means that if the auditor continues to provide

permissible NAS for a period of three or more years, then the NAS fee paid to the auditor will be capped to 70 per cent of the average total fee (audit and NAS) paid by a client. This is different from the U.S. requirements because it does not have a cap on permissible NAS. It seems that the new EU requirements are stricter than U.S. requirements when it relates to permissible NAS.

Furthermore, the U.S. regulators created a mandatory three year cooling off period before affiliated FAPs can serve as independent directors on a public company's board and audit committee. The regulators and critics argue that affiliated FAPs develop close ties with the client's management during their tenure as auditors, and hence may not objectively monitor the quality of management prepared financial reports. These FAPs also remain loyal to the audit firm and may compromise the independence of the external auditor.

Given these preceding summaries of regulation from some countries, it is important to note that there is no legislation or mandatory requirement in New Zealand that restricts the purchase of NAS from the auditor or require cooling off period for affiliated FAPs. Audit committees can purchase NAS without restriction and company directors are appointed without regulatory approval. Therefore, New Zealand presents a natural setting to evaluate whether FAPs on audit committees abet impairment of independence by purchasing more NAS from the auditor.

The research into the presence of FAPs on audit committees is relatively new in the literature with only two prior studies. These studies are Naiker and Sharma (2009) and Naiker, Sharma, and Sharma (2013). While both studies have similar conclusions, it is important to note that these studies are based on the U.S. environment and in the post-SOX era. The strict laws and regulations in the U.S. during the period of study may explain their findings, which cannot be generalised to jurisdictions that do not have pertinent regulations similar to the U.S. The current study offers new evidence from an environment (NZ) where the accounting and audit profession is self-regulatory, there is no ban on NAS, and also where there is low litigation risk for directors and auditors.

This present study examines how the presence of FAPs (affiliated and unaffiliated) on audit committees affect the purchase of NAS from the current auditor of the company. The study offers evidence to evaluate whether the appointment of FAPs to audit committees is beneficial to shareholders, who are principals of the FAPs serving as agents (directors) on the audit committee, in the context of NAS purchases from the auditor. The next section describes the birth and development of NAS.

1.2 The Birth of NAS

The growth of companies resulted in greater financing requirements. To finance expansion, some businesses sourced funds (in the form of debt) from financial institutions, while some raised finance through the stock markets (in the form of equity). Following this growth, shareholders appointed managers, who were responsible for managing the day-to-day operations of their businesses. This move created a separation of ownership between shareholders and management (Jensen and Meckling 1976).

The disengagement of shareholders from day-to-day operations of the business created the agency problem. Jensen and Meckling (1976) develop the agency theory to describe how managers' self-interests differ from shareholders' interests. Agency theory argues that the managers promote business activities that maximise their own utility and interests (e.g., compensation, misappropriation of assets) rather than shareholders' interests (e.g., stock returns, dividends, and efficient use of firm resources).

Jensen and Meckling (1976) suggest that to reduce agency problems, shareholders should incur agency costs of bonding and monitoring. As part of monitoring, shareholders require managers to prepare financial statements and have it audited by an independent external auditor.

The financial statement audit became compulsory in 1933, when the New York Stock Exchange (NYSE) established a rule that required independent audit of financial statements. Company failures in the 1930s also prompted the Securities and Exchanges Commission (SEC) to call for the establishment of audit committees in

order to strengthen the corporate governance framework of organisations. Although the SEC recommended audit committees, few companies complied. However, following the mandatory audit requirement, the audit profession grew exponentially. The audit profession grew further following the elimination of trade barriers in 1970s that prohibited audit firms from competing for clients (Zeff 2003).

By 1970s, the audit firms were led by non-accounting individuals who focused on making profits rather than upholding the values and ethics of the accounting profession (Zeff 2003).

The profit oriented audit firms began to venture into providing NAS to its clients. NAS are other services provided by auditors and are not related to the audit of financial statements. This new market was very lucrative for audit firms and enticed these firms to jointly provide NAS and audit services. At around the same time, many audit firms in the U.S. began to provide its services in other countries (Zeff 2003).

Following the corporate scandals in 1970s, critics began to highlight the issues with the audit profession and warned that auditors were losing credibility (Zeff 2003). However, it was the collapse of a few companies, such as Enron, Tyco and WorldCom around 2001, that changed the audit environment in the U.S. and around the world. Investors and employees lost billions in savings and investigations revealed that financial statements were misstated, which raised questions about the integrity and independence of auditors.

In October 2001, the Enron Corporation filed for bankruptcy in U.S. making it the largest corporate collapse in history at that time. Its auditors, Arthur Andersen was receiving approximately $1 million per week for audit and NAS from Enron. Investigations revealed that the management at Enron placed pressure on Arthur Andersen to assist it in misstating financial statements. Being a lucrative source of revenue (audit and NAS), Arthur Andersen gave in and acceded to management pressure. During the fall of Enron, Arthur Andersen partners directed its employees to delete or destroy documents related to Enron. Even before the fall of Enron, Arthur Andersen had been in trouble with the SEC for not following rules while

being auditors for Waste Management, Global Crossing, and Baptist Foundation of America (Kelly, 2006).

The continued destruction of Enron's documents attracted a number of political and legal criticisms. Arthur Andersen was indicted during Enron's fall, which exacerbated further after the collapse of another client, WorldCom. According to Kelly (2006), the Supreme Court decision in 2006 did not stop Arthur Andersen from practicing again but its image was destroyed, which prevented the reestablishment of the accounting firm.

The U.S. Congress conducted its investigations into the failure of Enron and Arthur Andersen and concluded that the joint provision of NAS and audit services played a major role in financial misstatements. The Congress enacted SOX in 2002, which was the strictest form of regulation for the audit profession. SOX bans auditors from jointly providing nine forms of NAS with audit services. Other countries have followed suit to enact similar regulations to influence the provision of NAS by auditors.

1.3 Non Audit Services (NAS)

Research in NAS has gained momentum in recent years after independence issues were highlighted during investigations on Enron and its auditors, Arthur Andersen. The shareholders hire auditors for financial statement audit while the management hire auditors to provide NAS.

It is argued that the joint provision of audit and NAS creates independence threats for the auditor (Sharma and Sidhu 2001; DeFond et al. 2002; Frankel et al. 2002; SEC 2003). The auditor, during the financial statement audit, would review various business activities. These reviews may include going through work that is classified as NAS work and completed by the same auditor. This creates self-review threats, which could affect the independence of the auditor (Leung et al. 2013; Naiker et al. 2013). Similarly, if an auditor engages in joint provision of NAS and audit services then the amount of fees can create economic dependence. If a client becomes a significant source of revenue for the auditor then the auditor may not disagree with

the client because doing so, may displease the client who may seek out and hire a more compliant auditor. The fear of losing a lucrative NAS client may incentivise an auditor from issuing an inappropriate audit opinion on the financial statements (Sharma and Sidhu 2001; DeFond et al. 2002; Frankel et al. 2002).

However, there are also some studies, which find that the joint provision of NAS and audit services create knowledge spillover benefits. These knowledge spillover benefits improve the efficiency of financial statement audits (Tanyi, Raghunandan and Barua 2010; Krishnan and Yu 2011; Knechel and Sharma 2012; Knechel et al. 2012). NAS allows the auditors to access client's business processes and acquire client knowledge that may not be available through the normal audit channels. This in turn, may lead to a higher quality financial statement audit.

1.4 The Financial Reporting Environment in New Zealand

The New Zealand audit environment is very small with around 160 firms listed on the New Zealand Exchange Market. The audit firms compete to attract clients by lowballing audit fees (Hay and Knechel 2010). With pressures to maintain their clients, external auditors in New Zealand may be lenient and thus may compromise their independence for economically important clients (Sharma et al. 2009).

Sharma et al. (2011) highlight that New Zealand has a self-regulatory audit environment. There is no legislation to restrict NAS purchases from the current auditor or any strict requirements to establish an effective audit committee. The Financial Markets Authority of New Zealand (equivalent to the Securities and Exchanges Commission in the U.S.) issued Corporate Governance Guidelines in 2004, which provides some (Sharma et al. 2009) corporate governance guidance for businesses. However, these guidelines are voluntary and a company has the option of not complying with this framework. Companies that comply with this framework are required to provide disclosures on audit committees and fees paid to the auditor. This framework also recommends that the audit committee maintain the independence of the auditor, which implies that the audit committee should ensure there are no auditor independence threats emanating from NAS purchases. However, there is no

regulatory limit on the amount of NAS that can be purchased from the auditor and managers can still create economic dependence for auditors.

From a supply side perspective, New Zealand has a low-litigation risk environment with limits on auditor liability and weak director liability provisions. A Commerce Clearing House database search over 18 years by Sharma et al. (2011) resulted in 417 corporate litigation cases, of which 14 included charges against the auditors. Out of this, only 6 cases have concluded with a judgement against auditors. There has been no landmark judgment to affect NAS purchase and FAP appointments to audit committees in NZ. As a result, auditors have the considerable freedom to provide NAS in any quantity while various stakeholder groups also support limits to auditor liability in New Zealand (Pacini et al. 2000), which further exacerbates issues relating to NAS.

1.5 Auditor Independence and NAS

The auditors' prospects of future and current income from a client may influence the audit opinion that will be issued following financial statement audits. The fear of losing the client may prevent the auditor from issuing qualified opinions (DeFond et al. 2002). However, some researchers also argue that any form of compensation can impair auditors' independence (Mautz and Sharaf 1961; Kinney and Libby 2002), implying that audit fees can also affect auditor independence.

After 2002, SOX, in the U.S. prohibits the provision of most forms of NAS from an auditor, who is also responsible for financial statement audits. Regulators argue that this section of SOX reduces the independence threats to some extent because it reduces the probability of economic dependence. However, it does not eliminate independence threats because the auditor still expects to receive some fees from the client in future (DeAngelo 1981; Beck et al. 1988).

In addition, an auditor is also not independent if it engages in lowballing audit fees. Lowballing is when auditors bid low audit fees to gain new clients. These lowballed audit fees may be so low that it may create losses for the audit firm. The auditor then plans to subsidise these losses by simultaneously providing NAS in large quantities.

Audit firms, which lowball audit fees, will fear losing their clients before all losses have been compensated. As a result, auditors will be less likely to displease the management and would accede to management pressure to issue inappropriate audit opinions (DeAngelo 1981).

In New Zealand, the auditor independence issues may be more pronounced because of its small and saturated audit market. At least 60 percent of companies are audited by the Big 4 audit firms (Knechel, Sharma and Sharma 2012). The audit market is very competitive and it is likely that auditors bid low audit fees to attract new clients and subsequently sell NAS.

1.6 Knowledge Spillovers and NAS

In another stream of the literature, researchers also find that the joint provision of audit services and NAS services creates knowledge spillover benefits and economies of scale for the auditor (Tanyi, Raghunandan and Barua 2010; Knechel, Sharma and Sharma 2012; Knechel and Sharma 2012). The provision of NAS allows the auditor to obtain knowledge of business processes. During the provision of NAS, the audit firm employees are put in management roles of the client. These employees obtain intricate knowledge about the various business processes (e.g., internal control). The auditors are able to complete preliminary audit procedures during the provision of NAS (e.g., control risk assessment). Since auditors complete preliminary audit tests during NAS, financial statement audits tend to require fewer audit hours, which implies efficiencies in the performance of the audit.

The detailed knowledge about business processes can also improve the quality of the audit. A higher quality audit ensures that financial statements contain fewer misstatements and the risk of earnings management is also low.

The competing issues emanating from the provision of NAS has been particularly important to regulators in U.S. and the EU. Studies have been mostly based on the U.S. environment, where NAS purchases have been affected by the strict regulation. This thesis examines New Zealand because regulators do not ban the purchase of

NAS from existing auditors (like U.S. and EU) nor require any preapproval from the audit committee (like Australia).

1.7 Audit Committees

Berle and Means (1932) suggest that the corporate governance framework helps avoid problems emanating from separation of ownership. The authors recommend establishing audit committees to act as an independent body within the organisation and be responsible for promoting shareholders' interests.

The Sarbanes-Oxley Act requires companies to create a separate audit committee composing entirely of independent directors (U.S. House of Representatives 2002; Sharma et al. 2009). Audit committees act as an additional form of governance within the organisation to inhibit managerial opportunism. In New Zealand, the formation of audit committees is required under the NZX Listing Rules but voluntary under the FMA corporate governance framework. Detailed discussion on the New Zealand environment is provided in Chapter 2.

An examination of audit committee regulations and guidelines from a number of jurisdictions reveals that audit committees are responsible for monitoring the quality of the financial reporting process of the organisation (including audit of financial statements) (Sharma et al. 2009).

A few studies also reveal that the effectiveness of an audit committee is determined by its composition, authority, resources and diligence (DeZoort et al. 2002). An effective audit committee is able to limit auditor dismissals (Lee et al. 2004), limit excessive NAS purchases, which could create economic dependence (Abbott et al. 2003a; Naiker et al. 2013), limit managers' influence on auditor opinions (Carcello and Neal 2003), limit earnings management (Abbott et al. 2004; Bedard et al. 2004; Agrawal and Chadha 2005), reduce internal controls deficiencies (Naiker and Sharma 2009) and reduce financial restatements (Abbott et al. 2003a).

1.7.1 Audit Committee Membership

Various guidelines recommend that audit committees should consist of experts to enhance the financial reporting process. Many studies find a negative association between audit committee financial experts and earnings management and financial restatements. Research prior to 2005 used broad measures of financial expertise (DeZoort et al. 1997; Abbott et al. 2003a). The literature has now evolved to examining specific forms of financial expertise present on the audit committee.

Naiker and Sharma (2009) and Naiker, Sharma and Sharma (2013) examine the effects of the presence of FAPs on the audit committee with internal control and NAS in the U.S. respectively.

FAPs are categorised as financial experts because of their extensive audit and accounting experience (U.S. House of Representatives 2002; Naiker and Sharma 2009; Naiker et al. 2013). Following SOX, companies faced difficulties in attracting professional directors to serve on company boards. Many hiring agencies then recommended FAPs as best candidates for company directorships (Naiker et al. 2013). Following the appointment of FAPs to the audit committee, critics then questioned the independence of these directors on the board and audit committee. The critics argued that FAPs have close relations with management developed during their tenure as lead audit engagement partners (Naiker et al. 2013). As a result, they argue that the relationship continues following the appointment of these affiliated FAPs to audit committees. Therefore, the affiliated FAP may not question various assertions and decisions of the management. This potential problem prompted the SEC to direct the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ) to design new rules. The SEC approved a rule in 2004 that requires affiliated FAPs to wait for a period of three years (‘cool off’ for three years) before being eligible to serve as independent directors for companies.

Two studies, which examine FAPs on audit committees, find that FAP presence is beneficial and is associated with reducing financial reporting deficiencies. Naiker and Sharma (2009) find that the presence of FAP on audit committee is negatively

associated with internal control deficiencies, while Naiker et al. (2013) find that FAPs are negatively associated with NAS purchases, which reduce auditor independence threats.

1.8 Objective and Contribution of this Thesis

The objective of this thesis is to investigate how FAPs on New Zealand audit committees influence the purchase of NAS from the current auditor. Following Naiker et al. (2013), this study also distinguishes between two types of FAPs; affiliated and unaffiliated FAPs.

Affiliated former audit firm partners (AFAPs) are members of the audit committee, who were former partners of the current auditor of the company while unaffiliated former audit firm partners (UFAPs) do not have any affiliation with the current auditor of the company. For example, if a company's current auditor is KPMG and has a director, who is a FAP from KPMG, then this director is classified as an affiliated FAP.

According to Naiker et al. (2013), various recruiting agencies in U.S. argue that AFAPs bring considerable insider knowledge and experience, which can assist a company in improving and maintaining a good financial reporting system. These AFAPs also possess industry specific knowledge to allow the company to gain advantage over competitors in the industry. Naiker and Sharma (2009) also argue that AFAPs possess knowledge on the internal control system of their former client and are able to identify and remediate any internal control weaknesses.

However, regulators and other critics argue that AFAPs cannot remain independent especially if it remains loyal to its former employer (audit firm), especially AFAPs. If the FAP is affiliated to the current auditor (former employer) then, the AFAP would provide more business to the auditor by approving more NAS purchases. This increase in NAS could create economic dependence, which then could prevent the auditor from exercising independence during the audit of financial statements (DeFond et al. 2002; Naiker et al. 2013).

Naiker et al. (2013) state that critics also argue that AFAPs are fully aware of the various audit tests that would be employed by the current audit engagement team. Hence, AFAPs will be able to circumvent audit tests by influencing the lead engagement partner. The current audit team will not question the AFAP because of seniority and experience (Naiker et al. 2013). Third, Naiker et al. (2013) argue that the AFAP, during the tenure as lead engagement audit partner, may have developed close ties with the management and now fails to question the management decision to procure NAS from the auditor.

Given the regulatory stance on FAPs and NAS in New Zealand, the main motivation of this thesis is to provide evidence to regulators on how NAS purchases are affected when FAPs are appointed to audit committees in a natural setting. Prior studies on FAPs examine audit committees in the U.S. setting, where greater litigation risks facing directors after SOX may explain the results found by Naiker and Sharma (2009) and Naiker et al. (2013). In contrast, New Zealand has no such regulations – it has a voluntary governance environment and no regulation on NAS - and hence, FAPs there may not face similar levels of litigation risk that could result in FAPs, especially, AFAPs, being associated with higher NAS.

The sample for this study consists of 980 firm-year observations listed on the New Zealand Stock Exchange between 2004 and 2013.

This study employs OLS regression to document that the presence of FAPs on audit committees is not significantly associated with NAS fees in New Zealand. The main finding is robust to several sensitivity tests. Further analysis is also conducted, where FAP is separated into AFAP and UFAP.

The results from this analysis indicate that AFAP is positively and significantly associated with purchase of NAS, while UFAP is negatively and significantly associated with NAS. Since higher NAS can either imply knowledge spillover benefits or threats to auditor independence, I perform further tests to evaluate, which of these two possibilities potentially motivate or explain the relationship between AFAP and higher NAS.

Audit lag is a proxy for knowledge spillover benefits and has been established in the literature (Knechel and Payne 2001; Tanyi, Raghunandan and Barua 2010; Knechel and Sharma 2012; Knechel et al. 2012; Walker and Hay 2013). It is defined as the number of days between the financial year end date and the audit report date. The literature posits that if knowledge spillover benefits exist from NAS (Knechel and Payne 2001; Knechel and Sharma 2012; Knechel et al. 2012), then the presence of AFAP should reduce the audit lag. However, the results indicate otherwise. AFAPs, who serve on audit committees, which approve purchase of higher NAS are associated with longer audit lags implying knowledge spillover benefits are unlikely to exist.

To examine if FAPs abet threats to auditor independence, the study regresses AFAPs on aggressive earnings management, a measure developed from Sharma and Kuang (2014). The results indicate that AFAPs who are present on audit committees, which purchase higher amounts of NAS are positively associated with aggressive earnings management. This result implies that auditor independence threats exist with the presence of AFAP who purchase higher NAS.

Following this, an analysis using audit fees reveals that AFAPs are associated with lower audit fees. This inverse relationship suggests that AFAPs are trying to influence the quality of financial statement audits by negotiating lower audit fees. AFAPs successfully lower audit fees and leave the auditor with limited budget to conduct the financial statement audits. Overall, these results suggest that AFAPs may not be independent monitors of the financial reporting process because of their connections to the auditors of the company.

This thesis has several contributions to public policy and the literature. It is the first study to examine FAPs on audit committees and NAS purchases in a setting where there are no regulations on limits to NAS, no restrictions of appointing former audit firm partners as directors in audit clients, and where the governance framework is voluntary. Second, since the study is situated in New Zealand and a natural setting, the results from this thesis provides evidence to New Zealand regulators to consider whether the joint provision of NAS and appointment of former audit firm partners affiliated with the audit client should be regulated. For example, the study has

implications on whether cooling-off rules similar to the SOX requirement in the U.S. should be considered by policy makers in New Zealand.

This is particularly important because the accounting profession is heavily regulated in many other countries but it is not in New Zealand. Third, this study is one of the three studies, which examine FAP appointments to the audit committee and only the second study to examine it with NAS purchases.

The thesis is organised as follows:

- Chapter 2 describes the New Zealand environment,
- Chapter 3 develops hypotheses following the discussion on prior literature of NAS and FAP appointments to audit committees,
- Chapter 4 describes the research design,
- Chapter 5 presents the results and discussion, and
- Chapter 6 concludes the thesis.

CHAPTER 2: AN OVERVIEW OF THE NEW ZEALAND ENVIRONMENT

2.1 Introduction

This chapter introduces the New Zealand environment as the setting of this study and discusses the development of financial reporting framework until 2013. It specifically examines key changes in New Zealand regulations following the introduction of the Sarbanes Oxley Act (SOX) in the U. S. The collapse of Enron and subsequent introduction of SOX, banned auditors from jointly providing most NAS to its audit client in the U.S. This move was made to bolster auditor independence. More recently, the European Parliament in 2014 agreed to ban the provision of NAS by the auditor within the EU countries. While changes were made to the financial reporting regulations in other countries, New Zealand regulators have not followed suit.

2.2 The Legal Environment for Companies in New Zealand

Public companies' rely on equity as the major source of funding. These funds are invested by members of the public and hence these companies are heavily regulated by governments around the world. These public companies are also listed on stock exchanges, which require companies to comply with more guidance and regulation. For example, the NZ Stock Exchanges require companies to comply with the International Financial Reporting Standards (IFRS). The New Zealand business law environment is governed by a number of Acts of Parliament. The main law is the Companies Act 1993 and is discussed in Section 2.3.1 of this Chapter. The next section examines the New Zealand financial reporting environment and describes provisions that affect the processes of listed companies.

2.3 The Financial Reporting Environment in New Zealand

A financial reporting framework comprises of the following; (1) an Act of Parliament, which is the Companies Act 1993, (2) the New Zealand Stock Exchange

Listing Requirements, (3) A set of Accounting Standards (International Financial Reporting Standards in New Zealand) (4) any other supplementary legislation (for example, the 1993 Financial Reporting Act in New Zealand) and (5) Voluntary Guidance (for example, Corporate Governance Guidelines issued by Financial Markets Authority in New Zealand).

2.3.1 The New Zealand Companies Act 1993

The New Zealand Companies Act of 1993 contains provisions that govern the formation, administration and liquidation of companies. However, the Act does not require a company constitution. This is advantageous because it allows the company to directly follow provisions defined in the Act. However, a constitution allows the company to modify the roles and powers of the shareholders, and may also allow directors to restrict their indemnity, insurance and share sales.

The Act defines directors' duties clearly and states that directors should:

1. *"Act in good faith and in best interests of company*
2. *Exercise powers for proper purpose*
3. *Comply with act and constitution*
4. *Not engage in reckless trading*
5. *Exercise duty of care*
6. *Must not agree to the company incurring an obligation unless the company will be able to perform the obligation*
7. *Disclose all material financial interests it might have in transactions*
8. *Not disclose any information achieved in the capacity of the director*
9. *Disclose information on the acquisition or disposal of shares at fair value*
10. *Ensure that accounting records are properly kept at all times; including a system of control to safeguard the records"*

Sections 200 to 202 of the Companies Act require:

(a) "every large company; and

(b) every company that is a public entity; and

(c) every large overseas company; and

(d) every other company with 10 or more shareholders unless the company has opted out of compliance with the provision in accordance with section 207I; and

(e) every other company with fewer than 10 shareholders if the company has opted into compliance with the provision in accordance with section 207K,

to prepare and present financial reports within 5 months of the end balance date".

These financial statements should include group results if the company has subsidiaries or is itself a subsidiary. According to Section 209, the board must send every shareholder a copy of the financial report and notice of meeting at least 20 days before the meeting. Moreover, the Act requires the financial reports to comply with the generally accepted accounting principles. New Zealand adopted the International Financial Reporting Standards (IFRSs) in 2005.

Section 207 of the Companies Act requires all companies mentioned in Sections 200 to 202 to have their financial statements audited by a qualified auditor.

It also requires audits to be carried in compliance with applicable accounting and auditing standards. The auditors' responsibility is to present the audit report to the shareholders and the External Reporting Board. The auditors also report to the Registrar if a company fails to comply with requirements specified in the Act.

The Act contains provisions to allow the shareholders of large companies to opt out of requiring audits of the financial statements. Section 207J states that *"The shareholders of the company may, at a meeting of shareholders held within the opting period, opt out of compliance with section 207 in relation to the accounting period by way of a resolution approved by not less than 95% of the votes of those shareholders entitled to vote and voting on the question"*.

Other companies, not mentioned in Section 200, are not required to prepare financial statements under the Act but Section 207K allows shareholders of these companies to opt in and prepare financial statements (Section 201/202), have it audited (Section 207) and prepare an annual report (Section 208).

Furthermore, the Act also requires auditors to be appointed at the annual general meeting if the financial statement is to be audited. The auditor holds office until the next meeting.

Section 207S states that auditors' fees and expenses should be fixed as soon as the auditor is appointed. Some auditor rights and responsibilities are also mentioned in the Act, one of which allows the auditor to attend shareholder meetings.

The period covered by this study is between 2004 and 2013. During this time, companies in New Zealand were governed by the 1993 Companies Act. However, the current Companies' Amendment Act was issued in 2013 and effectively applied from 2014. There have been no changes to the financial reporting requirements for companies.

Following the appointment of the auditor, the 1993 Act requires auditors to disclose the following in the audit report:

a. *"the work done by the auditor; and*
b. *the scope and limitations of the audit; and*
c. *the existence of any relationship (other than that of auditor) which the auditor has with, or any interests which the auditor has in, the reporting entity or any of its subsidiaries; and*
d. *whether the auditor has obtained all information and explanations that he or she has required; and*
e. *whether, in the auditor's opinion, as far as appears from an examination of them, proper accounting records have been kept by the reporting entity; and*
f. *whether, in the auditor's opinion, the financial statements and any group financial statements comply with generally accepted accounting practice, and if they do not, the respects in which they fail to comply; and*
g. *whether, in the auditor's opinion and having regard to any information or explanations that may have been added by the reporting entity pursuant to section 11(2) or section 14(2), the financial statements and any group financial statements give a true and fair view of the matters to which they relate, and, if they do not, the respects in which they fail to give such a view".*

The New Zealand Companies Act 1993 refers to auditor independence in Part C above. It requires auditors to disclose any interest in the entity. However, the Act is silent on specific interests, which may or may not relate to NAS purchased from the incumbent auditor and alma mater relationships such as a former partner of the audit firm serving as a director or employee of the audit client. One might reasonably expect both NAS and affiliations to fall under the ambit of Part C above.

2.3.2 The New Zealand Financial Reporting Act 1993

The purpose of the New Zealand Financial Reporting Act 1993 is to ensure the existence of the External Reporting Board. The External Reporting Board (XRB), created under Section 22 of the Financial Reporting Act of 1993, is an independent crown entity responsible for issuing accounting standards and auditing standards in New Zealand. The Accounting Standards Review Board was re-established as the External Reporting Board (XRB) in 1993, which was instrumental in approving the adoption of IFRS in New Zealand.

The Financial Reporting Act also requires the preparation and audit of financial statements as specified in Part 2 of the Act and is consistent with the Companies Act. Moreover, the Financial Reporting Act requires the registration of annual reports prepared by companies. The Financial Reporting Act does not mention auditor's duties in regards to the financial statement audit services and also does not mention issues affecting independence of auditors.

2.3.3 Auditor Regulation Act 2011

The New Zealand government recently enacted the Auditor Regulation Act of 2011. The purpose is to regulate auditors who carry out audits of reporting entities and to establish an independent oversight system. As part of regulatory requirements, auditors are required to be licensed by the FMA before being allowed to practice. Section 9 of the Auditor Regulation Act states that an audit firm should not accept audit engagements unless it is a registered audit firm, where all partners are licensed auditors.

The auditor accrediting bodies (Chartered Accountants Australia and New Zealand) issue 5 year licenses to auditors but also require them to engage in continuous competence programmes. The accrediting bodies can also recommend the registration of audit firms to the Registrar. The Registrar makes the final decision to accept the registration of audit firms. Overall, this Auditor Regulation Act is designed to regulate the quality of the audit profession and does not directly regulate the financial reporting of companies. The Act does not mention issues relating to the provision of NAS and audit services.

2.3.4 Accounting Standards

The Companies Act 1993 and the Financial Reporting Act 2013 provide the legal backing for the accounting standards. In New Zealand, the Financial Reporting Standards Board (FRSB) is the main accounting standard setter. The FRSB is privately funded and is part of the Chartered Accountants Australia and New Zealand.

Although the FRSB develops the accounting standards, the standards do not have legal backing immediately. The XRB is tasked to review and approve the standards proposed by the FRSB. These accounting standards get legal backing following the approval from the XRB.

In 2002, the XRB made a decision to adopt IFRS and require New Zealand companies to begin application from 2007, although early application was possible from 2005. According to Hickey et al. (2003), this decision to adopt IFRS in New Zealand was influenced by Australia's decision to adopt IFRS. The New Zealand XRB consulted with various stakeholders who supported the decision to adopt the IFRS. New Zealand is dependent on the Australian economy and followed suit when deciding to adopt IFRS.

New Zealand standard setters have either harmonised with IFRS directly or with Australian equivalents of IFRS and the accounting standards have been sector neutral since 1992.

2.3.5 The New Zealand Stock Exchange (NZX) Listing Requirements

According to its Website, the regulatory functions of the NZ Stock Exchange include:

- *"supervising listed issuers' (companies and other entities which issue securities) compliance with the NZX Listing Rules;*
- *supervising participants in NZX's markets, such as NZX Firms, NZX Advisors and Trading Participants;*
- *assisting the Financial Markets Authority as a co-regulator as required under the Securities Markets Act 1988 ("Act"); and*
- *assisting New Zealand Clearing and Depository Corporation Limited with the supervision and oversight of Clearing and Depository Participants."*

These functions are based on the following core Principles of NZX:

- *"all investors should be treated fairly and equitably.*
- *listed issuers should provide the market with full, timely and accurate disclosure information investors and market intermediaries should be protected against systemic risk.*
- *any unfair share trading practices should be detected and met with an effective sanction.*
- *market rules should be backed by effective mechanisms for investigation, surveillance and enforcement, with strong sanctions against deliberate breach of the rules.*
- *the costs of regulatory compliance should be minimised without compromising achievement of the other principles."*

Since 2004, the New Zealand Stock Exchange (NZX) Listing Rules have a more comprehensive set of corporate governance principles for companies as compared to the Companies Act and Financial Reporting Act described earlier. However, the rules are only applicable to companies listed on the New Zealand Exchange.

The NZX Rules require a Company Constitution to describe how the company expects to comply with the listing rules. Rule 3.2 provides guidance on the

appointment and rotation of company directors. Rule 3.3.1 requires that the board comprise of at least three directors of which two should be residents of New Zealand. At least a third of the board should comprise of independent directors. Moreover, one third of the directors are required to retire at each annual meeting with a chance of being re-elected.

Furthermore, Section 3.6 states that listed companies should establish audit committees, which should comprise of a minimum of three directors with majority being independent directors. It also requires at least one member of this audit committee to possess accounting or financial expertise. The independence requirement of the audit committee is vague and open to misinterpretation. It just requires majority of the audit committee members to be independent, while raising an important question on what majority means. Some may consider 50 percent to mean majority while others may consider a percentage over 50 to mean majority.

Further notes to Listing Rules define accounting and financial expertise as follows:
"A member of the audit committee will be deemed to have adequate accounting and financial background if he or she:

a. *is a member of the Institute of Chartered Accountants of New Zealand, or has held a Chief Financial Officer position at an Issuer for a period greater than 24 months; or*
b. *has successfully completed a course approved by NZX for audit committee; or*
c. *has the experience and/or qualifications deemed satisfactory by the Board"* (NZX Limited, 2012).

The Listing Rules also define various responsibilities of the audit committee. These are:

a. *"Ensuring that processes are in place and monitoring those processes so that the Board is properly and regularly informed and updated on corporate financial matters*
b. *Recommending the appointment and removal of the independent auditor*
c. *Meeting regularly to monitor and review the independent and internal auditing practices*

d. *Having direct communication with and unrestricted access to the independent and any internal auditors or accountants*
e. *Reviewing the financial reports and advising all directors whether they comply with the appropriate laws and regulations*
f. *Ensuring that the external auditor or lead audit partner is changed at least every five years"* (NZX Limited, 2012)

Finally, Rule 10.5 requires each issuer to prepare financial statements that comply with Financial Reporting Act 1993.

2.3.6 The New Zealand Financial Markets Authority Corporate Governance Guidelines

The Financial Markets Authority, the NZ regulator, also issues corporate governance guidelines for companies. These guidelines are exclusively for strengthening the governance framework of companies and apply to listed issuers, other issuers, state-owned enterprises, trusts and public sector entities. There are nine principles designed to improve the corporate governance framework, which are as follows:

1. *"Directors should observe and foster high ethical standards.*
2. *There should be a balance of independence, skills, knowledge, experience, and perspectives among directors so that the board works effectively.*
3. *The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.*
4. *The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.*
5. *The remuneration of directors and executives should be transparent, fair, and reasonable.*
6. *The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.*
7. *The board should ensure the quality and independence of the external audit process.*
8. *The board should foster constructive relationships with shareholders that encourage them to engage with the entity.*

9. *The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose."* (Financial Markets Authority, 2004)

This set of guidelines is voluntary and companies have the option of not applying the framework. The second principle of the framework requires the board to have an appropriate mix of independent, executive/non- executive directors, and to ensure that it is effective in decision making. The third principle recommends the board to establish board committees to assist directors in its responsibilities. This principle focuses specifically on the establishment of the audit committee. The Code states that the audit committee should comprise of the following:

- *"all non-executive directors, majority of whom are independent;*
- *at least one director who is a chartered accountant or has another recognised form of financial expertise; and*
- *a chairperson who is independent and not the chairperson of the board."*

The guidelines further state that the responsibilities of the audit committee are to:

- *"Recommend the appointment of the internal and external auditor*
- *Overseeing the entity-auditor relationship (independence)*
- *Promoting the integrity of the financial reporting"* (Financial Markets Authority, 2004)

The fourth principle requires the board to have processes to ensure quality and integrity in financial reporting. This includes compliance with various laws, establishment of internal control systems and a code of ethics.

An effective internal control system would assist the board in ensuring fair financial reporting. An effective internal control system would also place less pressure on the auditors. The risk of fraud and misstatements by management is also lower if internal control systems are effective.

The fifth principle focuses on director remuneration. It is important to ensure that the remuneration does not affect independent judgment of the non-executive directors.

The remuneration should be commensurate to appropriate skills, knowledge and experience. Director remuneration solely dependent on firm performance may impair independent judgment of the directors.

Another important corporate governance principle is on auditors. The board is required to ensure that auditors are appointed following rigorous process and needs to also ensure that there is no relationship between the auditor and the company. Furthermore, the lead engagement partner should be changed every five years. The board should also facilitate a full and frank dialogue between the auditors, audit committee and management. As disclosure requirements, this principle recommends that audit fees and NAS fees should be disclosed separately.

The principle also recommends that all NAS work should be presented in detail and also contain the board's explanation as to why the NAS did not impair auditor independence.

All preceding discussions described various rules and regulations, which influence the auditing process and the financial reporting process of companies in New Zealand. The next section examines the audit environment in New Zealand.

2.4 The Audit Environment in New Zealand

The New Zealand audit profession is a self-regulated industry when compared to audit industries in U.K., U.S. and Australia (Sharma, et al. 2011). This is because New Zealand does not have any independent agency to regulate audit services and NAS (like the Public Company Accounting Oversight Board and Financial Reporting Council in U.S. and U.K. respectively). The auditors are appointed by the board of directors and ratified at the annual general meeting by shareholders. The public auditing firms provide audit services to all NZ organisations except for government and municipal entities, which are audited by the Government Audit Office (Sharma, et al. 2011).

The majority of the audit market is dominated by the Big 4 audit firms; KPMG, PricewaterhouseCoopers, Ernst & Young, and Deloitte. According to Sharma et al.

(2011), the audit market in New Zealand is very competitive (evidenced by lowballing and solicitation in Hay and Knechel, 2010) because of the small number of companies that exist on the stock exchange. The Big 4 firms audit about 90 percent of all private and listed companies (Hay et al. 2006).

The presence of these factors indicate that audit firms in New Zealand would try to retain their clients by being innovative and providing other services. The provision of other services could create an economic bond between the auditor and the client, which can impair independent judgment of the auditor during financial statement audits. The fear of losing a valuable client could incentivise auditors to hide misstatements and internal control weaknesses.

SOX increased director duties, which raised the risk of director liability. This sent ripples throughout the world and many countries enacted own forms of legislations affecting NAS and auditor independence. Australia's regulations require audit committees to preapprove NAS purchases, while regulators in Europe have recently (in 2014) agreed to ban NAS purchases from incumbent auditors. However, there is no such regulation in New Zealand.

The New Zealand economy has had to face something similar to Enron in 1990s. New Zealand's largest audit failure occurred in 1994 when Fortex limited, a meat processing company closed operations (Hay, et al. 2006). Following this, the CEO of the company, who received many awards and accolades for good governance, was tried and convicted for falsifying financial statements. The auditors of the company, PricewaterhouseCoopers (PwC), were also sued for $130 million in damages. It was claimed that the Financial Controller and the Audit Partner had colluded to inflate income by misclassifying overseas loans as income and inflated the value of inventories. KPMG, the receivers, pursued PwC in order to recover $130 million for the creditors of Fortex Limited. Both accounting firms reached an out-of-court settlement. However, there were no subsequent changes to legislation and the CEO received only a jail term of six and half years. Therefore, companies in NZ can purchase and auditors can sell any amount and type of NAS.

2.5 Audit Committees in New Zealand

The formation of audit committees in New Zealand is guided by the FMA Corporate Governance Principles (2004), which is a voluntary corporate governance code. The guidelines in the Code are similar to those found in U.S. and Australia and companies have the discretion of determining the composition and responsibilities of the audit committees. Sharma et al. (2009) analyse the audit committee requirements in seven countries including New Zealand, and find that the guidelines in New Zealand are silent on issues relating to financial literacy, hiring of experts outside the audit committee, and internal control responsibilities of the audit committee. Table 2.1 summarises the differences.

On the other hand, the New Zealand Companies Act 1993, Financial Reporting Act 1993, and other Acts of Parliament are silent on whether the audit committee should be established. The prior discussions suggest that audit committee requirements are not strict because the regulators have allowed exemptions to some companies. The NZX Listing Rules and the FMA Corporate Governance Handbook recommend the appointment of non-executive directors to the audit committee, with majority being independent directors. There are no specific rules to guide FAP appointments to the audit committee and the board. However, the NZX Listing rules spell out some recommendations such as having a financial expert on the audit committee who is a chartered accountant or CFO with at least 24 months of accounting experience. All-in-all, the governance and specifically audit committee governance "regulations" are quite confusing as they are not consistent.

Based on the preceding sections and arguments, New Zealand provides a natural setting for examining the relationship between NAS purchases from the auditor and the appointment of FAPs to audit committees. Other countries have legislations to restrict NAS or regulate FAP appointments.

TABLE 2.1

Summary of Differences in Audit Committee Regulations From Five Jurisdictions

Feature	New Zealand	United States	United Kingdom	Australia	European Union
Regulation	Corporate Governance Principles and Guidelines	Sarbanes Oxley Act	The Combined Code	The Australian Stock Exchange Corporate Governance Principles and Recommendations	EU 8th Company Law Directive Audit Reform 2014
Formation	Voluntary, Comply or Explain	Mandatory	Voluntary, Comply or Explain	Voluntary, Comply or Explain	Mandatory
Size	Silent [a]	At least three members	At least three members	At least three members	Depends on the company
Composition	Majority Independent All non-executive directors Independent chair, who is not the chair of the board	All Independent	At least three directors independent	Majority Independent Independent chair	Dependent on member states All non-executive directors

Financial Literacy	Silent	All directors must be financially literate	Recommends all directors be financially literate	Recommends all directors be financially literate	Silent
Financial Expert	Recommends one expert, need not be independent	One expert, need to be independent	Recommends one expert, need not be independent	Recommends one expert, need not be independent	Recommends one expert, need to be independent
External Audit	Encourages audit committee to recommend appointment of auditor	Appoint, compensate, and oversee work of audit firm	Recommend appointment and compensation of the auditor	Recommend appointment and removal of the auditor, and rotation of engagement partners	Assess and recommend potential statutory auditors
	Oversee entity auditor relationship	Assess and review auditor's independence	Review auditor's independence	Review auditor's Independence	

NAS	Does not specify audit committee preapprove NAS provided by the auditor	Preapproval of SOX permissible NAS provided by the auditor	Does not specify audit committee preapprove NAS provided by the auditor	Does not clearly specify audit committee preapprove NAS provided by the auditor [b]	Preapproval of NAS provided by the auditor
Internal Control	Silent	Responsible under the SOX law to monitor the design and operating effectiveness of the internal control system; review management and auditor's report on internal controls	Review internal controls	Review internal controls	Monitor the effectiveness of internal control

[a] NZX Listing Rules require a minimum of three members on the audit committee

[b] The Corporate Economic Law Reform Programme 9 requires audit committees to preapprove NAS purchases in Australia.

Source: Financial Markets Authority, (2004); Sharma et al. (2009); PricewaterhouseCoopers (2014)

2.6 Summary and Conclusions

This chapter introduced the setting of this study by discussing the financial reporting and audit environment of New Zealand. There are many differences in legislations between New Zealand and other countries. In summary, the important requirements of the NZ Financial Reporting environment for listed companies are:

(a) Financial reports must be audited,
(b) Audit committees are voluntary,
(c) Majority of the audit committee members must be independent,
(d) NAS is not prohibited but the NAS fees should be disclosed in total and by type, and
(e) No restrictions or regulations on appointing to a client's board and audit committee former audit firm partners who worked for an audit firm that is the auditor of the audit client.

Hence, NZ serves as a natural setting to examine the NAS purchase behaviour of FAPs on audit committees. The results of this study can have important implications for NZ financial reporting policy makers and the accounting profession and for other jurisdictions that need to consider stronger regulation of the audit environment.

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CHAPTER 3: PRIOR LITERATURE ON NON AUDIT SERVICES AND AUDIT COMMITTEES

3.1 Introduction

There are numerous studies in the literature, which examine audit committees and non audit services (NAS). This chapter reviews the literature for studies on audit quality, NAS, audit committees and former audit firm partners (FAPs). It builds on the theoretical and quantitative analyses of these prior studies to develop the main hypotheses of the present study. The main objective of this study is to determine if there is a relationship and if so, the nature of this relationship, between FAPs who serve on audit committees and NAS purchased from the auditor in New Zealand.

3.2 Auditor Independence and Non Audit Services

NAS are other accounting services, which are different from financial statement audits, but provided by an auditor. In the 1970s, the U.S. Public accounting firms diversified into providing other accounting services to the public (Zeff 2003).

With questions on auditor independence, the Securities and Exchanges Commission (SEC) required companies to disclose the audit fee and NAS fees separately on the proxy form filed annually by companies in U.S. The Big 6 firms argued that NAS allowed them to obtain deeper knowledge of their client's business processes and also allowed them to carry out audits effectively. The 1979 SEC accountant accepted this idea and was successful in convincing the Public Oversight Board that no rules should prohibit the provision of NAS (Zeff 2003).

The audit firms' consulting (non audit) division grew exponentially from five percent in the 1970s to 28 percent of total gross fees by the 1980s (Zeff, 2003). This growth came after non-CPA's were hired to manage the audit firms. With no adequate knowledge on accounting services, non-CPA's served on top management positions at most of the Big 8 accounting firms. The non-CPA's focussed on profitability rather than professionalism and lacked knowledge of the code of conduct of the accounting profession.

This strategic focus was also a factor in driving the Big 8 accounting firms to become international accounting firms. Following their international presence, the eight accounting firms merged to eventually form the Big 5 accounting firms in the 1990s (Zeff 2003).

These profit-oriented accounting firms dismissed underperforming partners if they did not bring in sufficient business. The consulting division that began in the 1970s continued in the 1990s and the accounting firms continued to give importance to profitability rather than professionalism. Three U.S. companies (E.S.M Government Securities, ZZZZ Best and Wedtech Corp) failed in the 1980s and were alleged to have been caused by auditor fraud (Zeff 2003).

Regulators have always argued that as auditors provide more NAS and audit services, the fees received from the client increases. This increase in fees creates an economic bond between the auditor and the client. Consequently, the auditor may not exercise independent judgment during financial statement audits for such clients. The auditor may accept financial statements containing misstatements because of the fear of losing an economically significant client, which was exemplified in the U.S. by the Enron scandal, which resulted in the enactment of the Sarbanes Oxley Act in 2002.

Section 201 of the Sarbanes Oxley Act prohibits auditors from providing the nine forms of NAS services. The section states that *"it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit... contemporaneously with the audit, any non-audit service, including— ‘‘(1) bookkeeping or other services related to the accounting records or financial statements of the audit client; ‘‘(2) financial information systems design and implementation; ‘‘(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; ‘‘(4) actuarial services; ‘‘(5) internal audit outsourcing services; ‘‘(6) management functions or human resources; ‘‘(7) broker or dealer, investment adviser, or investment banking services; ‘‘(8) legal services and expert services unrelated to the audit; and ‘‘(9) any other service that the Board determines, by regulation, is impermissible."*

In addition, Section 202 requires audit committees to preapprove NAS purchases which are permissible by SOX. It states that *"all auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer."*

Section 202 also states that *"the preapproval requirement...is waived with respect to the provision of non-audit services for an issuer, if— ‘‘(i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the nonaudit services are provided; ‘‘(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and ‘‘(iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee."* Section 202 implies that auditor independence may be impaired if SOX-permissible NAS fees are more than five percent of the total fees paid to the auditor.

Following the Enron collapse and SOX, researchers have continued persistently to provide evidence that auditor independence is impaired when the auditors jointly provide audit and NAS by employing various proxies. These proxies are auditor reporting decisions (going concern modifications, modified audit opinions), discretionary accruals, earnings conservatism, and earnings restatement.

If an auditor's independence is impaired, it prevents the auditor from issuing appropriate audit opinions. If an auditor receives significant NAS and audit revenue from a client, it creates economic dependence. The qualified and going concern audit opinions displease the management. The auditor does not wish to displease the client because doing so would force the management to switch auditors. The auditors' fear of losing a significant client prevents them from issuing going concern opinions or qualified opinions when it is required.

The earliest studies were based in Australia because data was available. Various Australian studies (Wines 1994; Krishnan et al. 1996; Sharma and Sidhu 2001; Ye et al. 2011) find that the joint provision of NAS and audit services creates an economic bond and prevents auditors from issuing proper audit opinions. Several European studies also report evidence that the provision of NAS is negatively associated with issuance of going concern audit opinions (Lennox 1999; Basioudis et al. 2008; Ratzinger-Sakel 2013).

In a NZ study, Hay, Knechel and Li (2006) examine if auditors, who provide NAS, were less independent. The authors use data from top 200 NZ companies between 1999 and 2001 and the sample consists of 177, 224, and 243 companies for each of the three years respectively. They find that companies, which pay high NAS fees are less likely to receive going concern modifications. However, the study does not find a significant relationship between auditor switches and NAS. The study concludes that the joint provision of audit and non audit services does not affect the independence of the auditor.

Wang and Hay (2013) examine auditor independence in NZ by specifically examining audit fees, audit opinion and auditor tenure. The final sample consists of 99 observations from companies listed on the stock exchange in 2011. They find that independence may be impaired if non-Big 4 auditors are paid more NAS fees. This is because the results suggest a positive relationship between NAS fees and clean audit opinions issued by the non-Big 4 auditor.

Several researchers also argue that if an auditor receives significant amounts of NAS and audit revenue from a client, then the auditor will overlook financial misstatements and facilitate earnings management practices of the management. The auditors will fear losing significant clients by displeasing and disagreeing with management's assertions in the financial statement. Hence, the auditors will overlook deliberate misstatements in order to retain the client. Studies which examine this idea use discretionary accruals (Jones 1991; Dechow and Dichev 2002; Kothari et al. 2005) as a proxy for earnings management. A positive relationship between NAS and earnings management implies that the economic bond impairs auditors' independence.

Consequently, Ferguson et al. (2004); Srinidhi and Gul (2007) and Krishnan et al. (2011) find a positive relationship between NAS and earnings management in U.K., post-SOX and pre-SOX respectively.

Cahan et al. (2008) investigate NAS and earnings management in NZ. Their sample consists of 237 observations from between 1995 and 2001. The results suggest that an auditor providing NAS for a long time is positively associated with higher discretionary accruals.

Some studies also use restatements to document the impairment of auditor independence. The presence of restatements implies that prior period financial statements contained misstatements, which were not discovered during the financial statement audit of that year. If the auditor is not independent, then he/she might overlook earnings management and deliberate financial misstatements during the audit. These error and/or deliberate misstatements are discovered in the following year. Therefore, researchers in this paradigm speculate that NAS forces an auditor to overlook misstatements implying higher restatements in the subsequent year. Studies by Kinney et al. (2004) and Bloomfield and Shackman (2008) reveal some evidence that high NAS fees are associated with restatements, and Frankel et al. (2002) find NAS is positively related to earnings management in the U.S.

However, there are research studies that fail to find a significant association between provision of NAS and (1) going concern or qualified audit opinions (DeFond et al. 2002), (2) earnings management (Chung and Kallapur 2003) and (3) restatements (Raghunanadan et al. 2003).

Some NZ studies also failed to find evidence to conclude that NAS impairs auditor independence. Alexander and Hay (2013) examine NAS by disaggregating it onto recurring and non-recurring NAS. They posit that the disaggregated NAS is associated with audit fees. Using a sample of NZ companies between 1995 and 2001, they report that larger companies purchase NAS from the auditor and the most common form of recurring NAS are tax services. The main results suggest that auditors do not discount the audit fees when companies purchase recurring or non-recurring NAS. The authors argue that since the results suggest that NAS does not

have a negative effect on audit fee, it implies that auditors do not compromise audit quality.

The preceding discussion suggests that there is mixed results on whether auditor independence is affected when NAS is purchased from the auditor. The reason for the mixed results in various settings can be explained by the differences in regulation in each setting. However, the findings of studies in the same environment are also mixed. Regulators have enacted rules for listed companies and auditors in several jurisdictions but research has been inconclusive.

This implies that regulators are driven by some other motivation, such as company failures. At the same time, inconclusive results also raise the questions on the research methods that were employed (Carcello et al. 2014).

Carcello et al. (2014) use goodwill impairment accounting and report that the provision of NAS impairs auditor independence. The purpose of this study is to reconcile the mixed findings of studies, which examine the joint provision of NAS and audit services. With previous accounting standards, management amortised goodwill at a fixed rate. However, latest accounting standards require management to carry out impairment tests on goodwill. The amount of impairment depends on the judgment of financial statement preparers. The sample of this study consists of 3,615 U.S. companies, which have a material amount of goodwill recorded in the books but have a market-to-book value of less than one.

Carcello et al. (2014) reports three findings. First, NAS fees are negatively associated with the probability of a goodwill impairment. Second, impairment expenses are recorded late if NAS is high. Third, the amount of impairment expense recorded is lower, when NAS purchases are high. Overall, the results indicate that companies, which pay high amounts of NAS fees, receive preferential treatments from auditors when recording impairment losses on goodwill. The authors also state that this new measure is more reliable because it overcomes sample bias present in prior studies, which employed auditor opinion qualifications and going concern as a measure of auditor independence.

3.3 Non Audit Services and Knowledge Spillover Benefits

In a rebuttal to regulators, the audit firms argue that the joint provision of audit and NAS increases the quantity of information available to the auditor. While the audit firm is providing NAS, the employees visit the client more often and are able to use various methods to obtain more information to assist the audit team. In addition, important NAS engagements may also allow audit firm employees to access sensitive information. This information can also assist the audit team during financial statement audit. The audit team is better informed about the client and can exploit the new information to complete a higher quality financial statement audit.

Over time researchers have used various methods to show the presence of knowledge spillovers. Early U.S. studies which found evidence of knowledge spillovers focussed on showing a joint relationship between audit and NAS (Simunic 1984; Palmrose 1986; Antle et al. 2006; Krishnan and Yu 2010).

Later, U.S. studies began to employ audit lag as a measure of knowledge spillovers. Audit lag is defined as the number of days between financial year end date and the date the audit report is signed. Since auditors usually possess more information after providing NAS, the auditors would require fewer audit hours in assessing a client's activities during the financial statement audit. Researchers argue that if the joint provision of NAS and audit services creates spillover benefits then the audit lag is shorter. Subsequently, studies (Knechel and Payne 2001; Knechel and Sharma 2012; Knechel, Sharma and Sharma 2012) find that if auditors provide more NAS services, it is associated with shorter audit lags.

A few NZ studies have also examined audit lag and reported the presence of knowledge spillovers. Knechel, Sharma and Sharma (2012) examine the joint supply of NAS and audit services with audit quality using a sample of 230 firm-year observations from publicly listed New Zealand companies. They document that the joint provision of NAS and audit services are not significantly associated with a decline in audit quality but there is a significant negative relationship between audit lag and NAS. This implies the presence of knowledge spillover in NZ. In further analyses, the authors examine if knowledge spillover exists at audit city office level.

They find that the knowledge spillover benefits are limited to the city office level and not at national office level.

Walker and Hay (2013) examine audit report lag in New Zealand and find that NAS is associated with shorter audit lags. However, the knowledge spillover benefits (shorter audit lag) exist only in the subsequent period. This means that if NAS is provided in the current year, then knowledge spillover benefits are expected in the following year. Their sample, which had 260 firm-year observations, consists of all New Zealand companies listed on the NZ Stock Exchange between 2004 and 2005.

However, some knowledge spillover studies have failed to find significant evidence to conclude that the joint provision of NAS and audit services is beneficial. Davis, Ricchiute and Trompeter (1993) and Whisenant (2003) did not find significant evidence to support the existence of knowledge spillover argument.

Overall, there is mixed results in the knowledge spillover research. However, studies which employ audit lag as its proxy have consistently documented that the joint provision of NAS and audit services creates knowledge spillover benefits.

3.4 Prior Literature on Audit Committees

According to DeZoort (1997) the first audit committee was created in the United States during 1930s after there was a management fraud in McKesson and Robbins Inc. The external auditors failed to detect overstatement of assets and this prompted SEC to recommend the creation of audit committees as an additional form of investor protection. Increasing legal claims and awareness on the corporate governance framework created further demand for audit committees in the 1960s and 1970s. The U.S. Treadway Commission, established in 1985, saw the audit committee as an important component of effective corporate governance.

The audit committee is a committee of the board that is in charge of overseeing the preparation of financial report, external audit process, and the release of information to the market. Regulations have tried to define the composition of the audit committee in an effort to improve governance. Section 301 of SOX states that *"each*

member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent. In order to be considered to be independent... each member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee— ''(i) accept any consulting, advisory, or other compensatory fee from the issuer; or ''(ii) be an affiliated person of the issuer or any subsidiary thereof."

In addition, Section 407 requires at least one audit committee director to be a financial expert. It specifically requires public companies *"to disclose whether or not, and if not, the reasons therefore, the audit committee of that issuer is comprised of at least 1 member who is a financial expert."* Financial experts have been defined later in this chapter. The presence of financial experts assists the audit committee in reviewing the financial statements prepared by the management and ultimately assisting an effective oversight of the financial reporting process.

The audit committee is responsible for the financial reporting process and its responsibilities have changed over time because of the direct and indirect impacts of regulation. Section 301 of SOX states that *"the audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee."* SOX also allows the audit committee to engage other advisers to assist it in the financial reporting process. Section 301 also states that *"each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties".*

There are numerous studies on audit committees. DeZoort et al. (2002) synthesise the audit committee quality literature and identify four factors (composition, authority, resources and diligence) that affect the quality of the audit committee. Other

researchers have developed various measures to capture the effects of each of these indicators on financial reporting quality and audit quality. These proxies are:

First, independent directors are always concerned with their reputational capital. The reputational capital determines future employment opportunities for a director. The independent director protects reputation by actively monitoring the financial reporting process. As a result, many studies employ independence as a proxy to document its association with better financial reporting quality.

Research on audit committees in the U.S. finds that the presence of independent directors on the audit committee is associated with fewer discretionary accruals (McMullen and Raghunandan 1996; Abbott et al. 2000; Beasley et al. 2000; Beasley and Saleterio 2001; Klein 2002; Bedard, Chtourou and Courteau 2004; Vafeas 2005).

In addition, the presence of independent directors allows the auditors to maintain their independence. Studies find that independent directors are associated with lower possibility of auditor switches (Lee, Mande and Ortman 2004). The independent audit committee allows the auditor to issue correct audit opinions without the fear of losing a client.

The independent directors on the audit committee also allow auditors to use the most contending negotiation position with the management. Auditors are more likely to be successful in negotiating correction of misstatements if the audit committee has independent directors (Brown-Liburd and Wright 2011; Keune and Johnstone 2012).

Results from Australian studies also agree that audit committees are an important governance mechanism. Chen, Moroney and Houghton (2005) and Goodwin-Stewart and Kent (2006) find that the presence of non executive directors is positively associated with the quality of audit firm used and better audit quality of financial statements. Nelson, Gallery and Percy (2010) find better compliance to executive compensation disclosures when the audit committee is independent and effective.

Second, the presence of financial expertise is another factor, which improves the quality of the audit committee and the quality of the financial reporting process. The

financial expert is better equipped with technical expertise to assess management's assertions and is in a better position to identify deliberate misstatements in the financial statements.

Some U.S. studies examining the presence of financial experts report negative association with earnings management, financial misstatements and poor accruals quality (McMullen and Raghunandan 1996; Cohen and Hanno 2000; Raghunandan et al. 2001; Bedard, Chtourou and Courteau 2004; Krishnan and Visvanathan 2008; Dhaliwal, Naiker and Navissi 2010; Carcello et al. 2011; Seetharaman et al. 2014).

The presence of financial experts on the audit committee also assists directors in strengthening the internal control processes of the company. Goh (2009) finds that the presence of financial experts is associated with a timely remediation of material weaknesses.

In Australia, Baxter and Cotter (2009) find that audit committees and financial expertise on audit committees are associated with fewer earnings management.

Third, audit committee meetings is another measure of effectiveness. However, there are competing viewpoints. If an audit committee meets often, then it implies that the directors are actively involved in monitoring the financial reporting process. However, more meetings could also indicate a reactive audit committee implying that the audit committee meets often to solve issues that have arisen in the financial reporting process.

Consequently, researchers find that audit committee meetings are positively associated with specialist auditors (Abbott and Parker 2000), while Raghunandan and Rama (2007) document that audit committee meetings are positively associated with larger firms, litigious industries, high outsider block-holdings and board meetings. Stewart and Munro (2007) find that audit engagement partners spend more time with the client if it has to attend audit committee meetings frequently.

Audit committee research in NZ has also reported results consistent with U.S. studies. Rainsbury, Bradbury and Cahan (2008) investigate the demand and supply

characteristics associated with audit committee compliance to the 'best practice' guidelines. The sample consists of 56 firms listed on the NZ stock exchange in 2001. The results suggest that supply factors (board size and board independence) are positively associated with effective audit committees, which comply with all best practices. However, demand factors (leverage, growth opportunities, large audit committees) do not have strong relationships with best practice and effective audit committees.

In a comprehensive NZ study, Sharma, Naiker and Lee (2009) examine the relationship between audit committee meeting frequency and other indicators of an effective audit committee and governance. Using 96 firm year observations from the main board of the NZ stock exchange, they find that there is a positive relationship between audit committee meetings and low growth firms, management ownership, larger audit committee, greater board independence, accounting experts on the audit committee, and greater institutional ownership. The authors find a negative relationship between the frequency of audit committee meetings and the presence of a Big 4 auditor, companies operating in highly regulated industries, audit committee independence, independent chair of the audit committee, and multiple directorships.

Sharma and Kuang (2014) examine aggressive earnings management and audit committees in New Zealand using a sample consisting of 194 firm-year observations from New Zealand Stock Exchange between 2004 and 2005. However, they find that independent audit committees do not have a relationship with aggressive earnings management, while non-executive and executive directors, who own shares tend to be positively associated with earnings management.

Overall, the strength of the audit committees plays an important role in client acceptance decisions. Auditors choose clients with strong audit committees (Cohen et al. 2002). The audit committee is also instrumental in NAS purchase decisions. As mentioned in the prior section, NAS creates auditor independence threats. An effective (independent, with financial expertise) audit committee is able to mitigate independence issues created by the joint provision of NAS and audit services. The next section examines prior literature on NAS and audit committees.

3.5 Prior Literature on Audit Committees and Non Audit Services

An effective audit committee is interested in maintaining the independence of the external auditor and support purchase of fewer NAS because of three reasons. First, the audit committee decisions are based on protecting directors' reputation and preventing possible lawsuits. Most company directors serve on multiple boards and such directors are interested in future employment on other company boards. If a company misstates financial statements, the blame is placed on the directors, which spoils their reputation. This affects the directors' opportunities for future employment. The independent directors exercise extreme care to protect their reputation when making company decisions. Such concerns will encourage the audit committee to promote auditor independence as well (Abbott et al. 2003a).

Second, SOX bans NAS purchases from the auditor so audit committees may naturally approve fewer NAS (Abbott et al. 2003a). Third, if the joint purchase of NAS and audit services reduces audit quality then the audit committee intervenes and prevents further purchases of NAS (Abbott et al. 2003a).

Accordingly, several studies find a negative and significant relationship between NAS and effective audit committees in U.S. Abbott et al. (2003a) examine the relationship between the ratio of NAS fees and the characteristics of the audit committee and hypothesise a negative relationship between the two constructs. They use a sample size of 538 proxy form filings with the SEC between February and June 2001 to document that fully independent audit committees, which meet for at least four times annually are significantly and negatively associated with NAS fees.

Abbott et al. (2003a)'s finding implies that the pressure of maintaining reputational capital prevents the independent directors on the audit committee from approving the joint purchase of audit and NAS from the auditor. The data is from the pre-SOX period therefore regulation does not explain their results.

Lee and Mande (2005) also examine the NAS – audit committee relationship in U.S. They argue that audit fees and NAS fees are endogenous while criticising Abbott et al. (2003a) for not considering the endogeneity of audit and NAS fees. Their data

consists of 792 U.S. firms whose financial year ended on 31st December 2000. Their results confirm Abbott et al. (2003a)'s findings that effective audit committees are inversely related to NAS fee ratio. However, after they consider the joint relationship of audit and NAS fee, Lee and Mande (2005) report that there is no statistical relationship between the two types of fees and the effectiveness of the audit committee. They conclude that Abbott et al. (2003a) find a spurious relationship in a single equation system.

Gaynor, McDaniel and Neal (2006) use the 2 x 2 between-participants experiment method with 100 participants to examine effective audit committees and NAS in U.S. The main aim of this study is to look at how NAS purchases are affected when the audit committee faces public disclosure requirements. They hypothesise that the audit committee tries to reduce NAS purchases if it has to disclose fees in the financial statements. Following the results of the experiment, the authors use logistic regression to test the relationship between NAS and public disclosure.

Gaynor, McDaniel and Neal (2006) also include an interaction variable to test if public disclosure requirements moderate NAS purchases. The results suggest that audit committees are reluctant to allow the auditor to provide NAS even if there is no public disclosure requirement. Audit committees are naturally concerned with auditor independence issues emanating from NAS. This study also supports the argument that audit committee directors are concerned with protecting reputational capital.

Lee (2008) examines the relationship between an effective audit committee and NAS fee ratio in the U.S. The author specifically examines 631 companies, which had financial year ending in December 2000 and 2001. The author finds that effective audit committees are related to a lower NAS fee ratio. The effectiveness measure is a composite variable encompassing independence and financial expertise of the board and audit committee. The results suggest that an effective audit committee is interested in safeguarding the independence of the auditor, supporting the SOX requirements on audit committees and associated with lower NAS fee ratio.

In a U.K. study, Zaman, Hudaib and Haniffa (2011) examine the effectiveness of audit committees and NAS fee using another composite measure. Their sample consists of 155 companies listed on the U.K. stock exchange between 2001 and 2004. The composite measure includes the independence, presence of financial expert, meetings and size of the audit committee. In addition, they also test each factor separately with NAS fees. The results suggest that the composite measure is positively associated with NAS fees, while more NAS fees are associated with larger audit committees, more audit committee meetings, fewer independent directors on the audit committee and a lack of financial expertise on the audit committee.

The prior studies discussed earlier consistently report that the presence of financial expert on an audit committee is associated with fewer NAS purchases in both U.S. and U.K. setting. After SOX, the presence of financial expert on the audit committee became a mandatory requirement in U.S. SOX broadly defined financial expertise and implies that directors with varying experience and qualification could be classified as financial experts.

Section 407 of SOX defines financial experts as "*a person [who] has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions— (1) an understanding of generally accepted accounting principles and financial statements; (2) experience in— (A) the preparation or auditing of financial statements of generally comparable issuers; and (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves; (3) experience with internal accounting controls; and (4) an understanding of audit committee functions*".

Subsequent research studies recognised that financial experts who are former audit firm alumni began to serve as company directors and/or managers in U.S.

3.6 Prior Literature on Audit Firm Alumni, Audit Committee and Audit Quality

3.6.1 Former Audit Firm Partners appointed as Officers in a Company

There is evidence that the board and management of organisations now comprise of the former employees of audit firms. The presence of former audit firm employees or partners in senior management team or as a board member could be both beneficial and detrimental to the company.

Section 206 of SOX bans audit firms from providing audit services to companies, whose CEO, CFO, controller or chief accounting officer was employed by the audit firm one year preceding the audit engagement.

Subsequent studies examine how the presence of former audit firm employees affects the level of earnings management. Menon and Williams (2004) argue that companies which employ a FAP as an officer or a director can create auditor independence issues. This issue was highlighted following Enron's failure. Many Arthur Andersen employees went on to work for Enron, who created auditor independence problems by keeping ties with Arthur Andersen's current employees.

The presence of former audit firm employees as an officer and/ or director reduces the audit risk for the incumbent auditor in two ways. First, the current audit engagement team reduces assessed control risk because of their confidence in FAP's ability to maintain good internal control. Second, the auditors reduce inherent risk because of the integrity of the FAP. Subsequently, the audit team begins to over-rely on the FAP and fail to exercise professional scepticism, which can cause audit errors (Menon and Williams 2004).

Menon and Williams (2004) examine the presence of FAP as officer or director with discretionary accruals, a proxy for earnings management. Their sample consists of 10,735 U.S. firm-year observations from 1998 and 1999, which includes 840 firm-years representing FAPs as directors or managers. Some 402 firm-year observations represent FAPs who serve as CEOs, CFOs or on other financial reporting oversight

roles, 142 firm-years represent FAPs who serve in other officer positions and 296 firm-years with FAPs who serve as non-executive directors.

Menon and Williams (2004) employ the Jones (1991) abnormal accruals model and report that the FAPs employed as officers or directors are related to impaired auditor independence and more unsigned abnormal accruals. Further analyses reveal that abnormal accruals are not explained by FAPs' expertise in financial reporting. The result implies that abnormal accruals occur due to the independence issues, which are created after the FAP is hired.

Furthermore, the former audit firm employees possess intricate knowledge about the company's processes and knowledge about the audit plan. The former audit firm employees may circumvent audit tests and prevent a proper audit of the financial statements. This is because the former audit firm employees in the capacity of a CFO CEO or director are considered to be more experienced than the audit engagement team. The team members will not question the former audit firm employee's decisions relating to financial reporting.

Dowdell and Krishnan (2004) examine how the appointments of CFOs, who have past employment relationship with the audit firm, affect discretionary accruals. The authors hypothesise that discretionary accruals are higher for companies that appoint CFOs from audit firms. Furthermore, they also examine how the level of former employment in the audit firm affects discretionary accruals. The sample consists of 172 FAP and 172 control companies between 1993 and 1997. Using the Jones (1991) discretionary accruals model, the authors report that the practice of earnings management increases after the former audit firm employees are hired as CFOs.

According to Lennox and Park (2007), a large number of audit firm alumni provide benefits to the audit firm they are affiliated with. Their sample consists of 189 public companies between 1995 and 2000. A total of 214 officers, who serve on these 189 companies have alumni relations with the audit firm.

The study finds evidence that if the alumnus gets its affiliated audit firm appointed as the auditor, he/she can engage in earnings management, which the auditor may be

forced to overlook. The study also finds that companies appoint officers' from audit firms when the audit committee is not independent.

However, Geiger, North and O'Connell (2005) fail to find a significant relationship between earnings management and hiring former audit employees to fill financial reporting (CFO) positions. The sample consists of 202 U.S. public companies between 1989 and 1999, of which 101 companies had appointments from audit firms and 101 matched companies.

Lennox (2005)'s study hypothesises that clean audit opinions are issued to companies that have affiliated executives and also expects that the departure rate of affiliated executives is lower than unaffiliated executives. The study employs two logit models and data from U.S. listed companies between 1995 and 1998. The results suggest that companies receive clean audit opinions more often if the affiliated executives are hired from audit firms. Further analyses suggest that affiliated executive departures are infrequent as compared to unaffiliated executives only if companies view affiliated executives to be more valuable, that is, if clean audit opinions are received.

Overall, the studies discussed in this section have generally found that the presence of FAPs or other audit firm employees as senior managers is not beneficial to the financial reporting process of companies. However, these studies have not separated and examined FAPs or other audit firm employees, who serve as board directors or audit committee directors of companies. In the next section, I examine the only two studies, based in U.S., which have reported that the presence of FAPs on audit committees is beneficial to public companies.

3.6.2 Former Audit Firm Partners Appointed to Audit Committees

In the pioneering studies, Naiker and Sharma (2009) and Naiker et al. (2013) examine the presence of a former audit firm partner on the audit committee. An audit committee can either have affiliated FAPs or unaffiliated FAPs or both. Naiker et al. (2013) separate and suggest that two types of former audit firm partners can be present on the audit committee. These are affiliated and unaffiliated former audit firm partners. Affiliated former audit firm partners (AFAPs) are directors of the

company and share some relationship with the incumbent auditor of the company. These AFAPs are expected to also have close ties with the management and auditor. The unaffiliated former audit firm partners (UFAP) do not have a past employment relationship or any affiliation with the incumbent auditor of the company.

Both these studies on FAPs provide arguments that the presence of FAPs is (1) beneficial and (2) detrimental to a public company. In addition to the arguments presented in the immediate prior section, Naiker and Sharma (2009) argue that during prior audit engagements, the AFAP may have developed close ties with the management and now fails to question (in the capacity as the member of the audit committee) the management on the irregularities in internal control.

In their second study, Naiker et al. (2013), who solely examine how NAS purchases are affected when a FAP is present on the audit committee, argue that AFAPs, having been employed by the audit firm, is still loyal to the audit firm. Alternatively, the AFAP has developed ties with the management and does not question management's decision to purchase more NAS from the auditor. Other members of the audit committee will allow this AFAP to influence discussion and will subsequently accept the AFAPs decision to approve higher NAS purchases. Prior studies have associated high NAS purchases with an impairment of auditor independence. This is consistent with the group theory discussed in their paper. The group theory posits that when a group of people have to make a decision, they will concur to the decisions of the group member, who is the expert on the issue (Kameda et al. 1997). The experts become more influential because of the knowledge they possess.

However, Naiker and Sharma (2009) and Naiker et al. (2013) also suggest that there are benefits of appointing FAPs to the audit committee of a company. FAPs possess considerable experience, expertise and knowledge that may assist a company in its financial reporting process. These FAPs have detailed knowledge of the company's internal business structure and specialist knowledge about the company's industry. Their expertise can assist the board in discharging its financial reporting responsibilities (Naiker and Sharma 2009).

Naiker et al. (2013) argue that AFAPs will make conservative NAS purchase decisions for two reasons. First, the AFAP in the capacity of the director is more concerned with protecting reputational capital and avoiding lawsuits. NAS is known to impair auditor independence and is closely related to financial misstatements (discussed in earlier sections). The AFAP with other directors on the audit committee will prevent high NAS purchases to protect their reputation. Second, SOX now requires preapproval and signed disclosure of all NAS purchases made by a company in the United States, which also discourages NAS purchases.

Naiker and Sharma (2009) hypothesise that the presence of FAPs on audit committees is associated with fewer incidences of internal control deficiencies, while Naiker et al. (2013) hypothesise that the presence of UFAP or AFAP on audit committees is associated with fewer NAS purchases.

To test their proposition, Naiker and Sharma (2009) employ 1,225 U.S. observations from 2004 fiscal year while Naiker et al. (2013) examine 2,748 observations from 2004 and 2005 fiscal years, implying that both are post-SOX studies. Their sample is from the period when NAS was banned and three year cooling off rules were enforced.

Naiker and Sharma (2009) find that there is a negative relationship between disclosure of internal control deficiencies and the presence of FAPs on the audit committee. Naiker et al. (2013) document that the presence of UFAP or AFAP is significantly associated with fewer NAS purchases. The FAPs on U.S. audit committees promote auditor independence and do not compromise financial reporting. These findings are robust because a number of additional analyses support the same conclusions. With these findings, both studies question the validity of having a mandatory three year cooling off period for AFAPs.

As mentioned earlier, audit committee directors reduce NAS purchases (1) to protect their reputational capital, (2) to comply with regulation or (3) to prevent low audit quality. Since both these studies are in the post-SOX period, directors face higher litigation risks and risks of losses to reputational capital. Moreover, SOX bans NAS, while SEC enforces the cooling off rule. These reasons explain why Naiker et al.

(2013) find a negative relationship between the presence of FAPs and NAS. This present study on NZ is different because there is no such law to affect FAP behaviour.

In this study's context, the group theory described by Naiker et al. (2013) can also be used to predict possible NAS purchase behaviour in New Zealand. The other members of the audit committee will agree to the NAS purchase decision proposed by the FAP because the FAP has and/or is perceived to have the most knowledge about the NAS purchase decision of a NZ company. Despite the two competing arguments about FAPs by Naiker and Sharma (2009) and Naiker et al. (2013), I propose that in a different regulatory environment such as New Zealand, where there are no bans or limits on NAS, no cooling off periods for FAPs, voluntary corporate governance regulations, and litigation against directors and auditors are negligible, the first hypothesis of this thesis posits that:

H1: Audit committees with former audit firm partners (FAPs) in New Zealand will procure more non audit services (NAS) from the company auditor compared to audit committees that do not have former audit firm partners.

Naiker et al. (2013) categorise FAPs into AFAPs and UFAPs. If the FAP on the audit committee of a company is affiliated with the incumbent audit firm then there are chances that more NAS will be purchased from the auditor. This is because the AFAP has stronger ties (e.g., loyalty, personal ties) with the incumbent audit firm than the UFAP. However, UFAPs do not have such affiliations and may not have incentives to purchase more NAS from the auditor. The second hypothesis is:

H2: Audit committees with affiliated former audit firm partners (AFAPs) in New Zealand will procure more non audit services (NAS) from the incumbent auditor compared to audit committees with unaffiliated former audit firm partners (UFAPs).

3.7 Summary and Conclusions

This chapter presented the prior literature on NAS, audit committee and FAPs. The literature on FAPs is limited and is even smaller for FAPs on audit committees. This present study is the third to examine FAPs on the audit committee and the second to examine it with NAS fees. However, it is the first study to examine the idea in New Zealand. Overall, the purchase of NAS can be associated with impaired auditor independence or associated with knowledge spillover benefits. The current literature is trying to disentangle and explain whether the purchase of NAS is beneficial or not. The present study tries to create its own contribution by trying to disentangle the competing viewpoints from the perspective of FAPs serving on audit committees.

CHAPTER 4: RESEARCH DESIGN

4.1 Introduction

This chapter presents the research methods that will be employed in this thesis. A NAS fee regression model is introduced, which has been used in prior studies and known to have significant explanatory power. Naiker et al. (2013) test the presence of former audit firm partners (FAPs) in the U.S. This study adopts their model to test the effects of FAPs on NAS in New Zealand. The hypothesis developed in the previous chapter is to be tested using this model. Following this, the chapter also describes the sample and the data collection processes. The final section of the chapter contains a description of robustness and sensitivity tests of this study.

4.2 Modelling NAS

An empirical model of NAS is employed in this thesis, which already exists in prior research. According to the hypotheses developed in the previous chapter, the presence of FAPs on audit committees is expected to be positively associated with the purchase of NAS from the auditor. The study employs the following model to test H1:

$$\begin{aligned} FEERATIO = {} & \alpha + \beta_1 FAP\_DUM + \beta_2 OTHER\_ACCTG\_DUM + \beta_3 FINANCE\_DUM \\ & + \beta_4 SUPER\_DUM + \beta_5 ACSIZE + \beta_6 ACIND + \beta_7 LNAC\_MEET + \\ & \beta_8 BODSIZE + \beta_9 BODIND + \beta_{10} LN\_BODMEET + \beta_{11} BIG4 + \\ & \beta_{12} INITIAL + \beta_{13} CEO\_DUALITY + \beta_{14} LOSS + \\ & \beta_{15} SALES\_GROWTH + \beta_{16} DEBTCHANGE\_DUM + \beta_{17} LEV + \\ & \beta_{18} LN\_ASSETS + \beta_{19} BM\_RATIO + \beta_{20} ANNRET + \beta_{21} FOROPS + \\ & \beta_{22} EMPLAN + \beta_{23} MERGE + \beta_{24} RESTR + \varepsilon_i \end{aligned}$$

It is also posited that affiliated former audit firm partners (AFAPs) would purchase more NAS than unaffiliated former audit firm partners (UFAPs). This is because AFAPs remain loyal to their former employer (current auditor of the company) and may approve purchase of more NAS (Naiker et al. 2013). To test the second hypothesis H2, the thesis introduces two test variables and employs the following model:

$$FEERATIO = \alpha + \beta_1 AFAP\_DUM + \beta_2 UFAP\_DUM + \beta_3 OTHER\_ACCTG\_DUM + \beta_4 FINANCE\_DUM + \beta_5 SUPER\_DUM + \beta_6 ACSIZE + \beta_7 ACIND + \beta_8 LNAC\_MEET + \beta_9 BODSIZE + \beta_{10} BODIND + \beta_{11} LN\_BODMEET + \beta_{12} BIG4 + \beta_{13} INITIAL + \beta_{14} CEO\_DUALITY + \beta_{15} LOSS + \beta_{16} SALES\_GROWTH + \beta_{17} DEBTCHANGE\_DUM + \beta_{18} LEV + \beta_{19} LN\_ASSETS + \beta_{20} BM\_RATIO + \beta_{21} ANNRET + \beta_{22} FOROPS + \beta_{23} EMPLAN + \beta_{24} MERGE + \beta_{25} RESTR + \varepsilon_i$$

A discussion of the dependent variable, independent variables and control variables is presented next. Table 4.1 summarises the definitions of these variables.

4.3 Dependent Variable: NAS

The main dependent variable is FEERATIO, which is the ratio of NAS fees to total fees paid by a client to its auditor. I use this measure because Naiker et al. (2013) employ FEERATIO as the dependent variable in their study, and posit that higher NAS fees as a proportion of total fees paid to the auditor can raise concerns about the auditor becoming economically bonded to the client.

Since Naiker et al. (2013) employ various alternative measures of NAS, this study will also employ such measures in its sensitivity and robustness tests. Following Naiker et al. (2013), the following additional measures for the dependent variable include (i) the natural logarithm of the dollar amount of NAS, (ii) the ratio of NAS fees to audit fees, and (iii) unexpected NAS fees. This measure is calculated as the residual of the NAS fee model, which includes all control variables and natural logarithm of NAS as dependent variable.

4.4 Independent Variables - Variables of Interest

4.4.1 Former Audit Firm Partner

There are three variables, which capture the presence of former audit firm partners on the audit committee. FAPs are accounting and/or audit experts, who serve on audit committees following their tenure in an audit firm. This thesis employs three independent variables because the study has to address two hypotheses developed in

the previous chapter. All these independent variables are dichotomous variables. The first hypothesis examines the association between the presence of a FAP on the audit committee and NAS without examining affiliation of FAPs. This means the first variable, FAP_DUM, is coded 1 if an audit committee has at least one former audit firm partner on it and 0 otherwise. Information on audit committee directors is obtained from biographies presented in the annual reports of companies.

For instance, the following biography was presented in the 2013 Annual Report of Sky Entertainment Television Limited, and bold emphasis has been added to highlight pertinent information:

"John Waller

Mr Waller was appointed a director of SKY and member of the audit and risk committee in April 2009. He was a ***partner at PricewaterhouseCoopers for over 20 years,*** *was a member of their board and led their Advisory practice. He is the chairman of BNZ and the Eden Park Trust Board, and a director of Fonterra Co-operative Group Limited, National Australia Bank Limited, Alliance Group Limited, Donaghys Limited, Property for Industry Limited and various other companies".* (Sky Entertainment Television Limited 2013, p. 31).

In Corporate governance section of the Annual Report, the following paragraph confirms that the FAP is also a member of the audit committee.

"Audit and Risk Committee

The audit and risk committee is responsible for overseeing the financial and accounting activities of SKY including the activities of SKY's auditors, accounting functions, internal audit programmes, financial reporting processes and dividend policies. The committee operates under a formal charter and, in addition to its audit functions, is responsible for establishing and evaluating risk management policies and procedures for risk assessment. The current members are Robert Bryden, ***John Waller*** *and Humphry Rolleston".* (Sky Entertainment Television Limited 2013, p. 86).

Following this, I code FAP_DUM as 1 because SKY Limited has a FAP on the audit committee.

The second hypothesis postulates that the affiliations of these FAPs affect the firm's decision to purchase NAS from the auditor. To test this, the study splits FAP_DUM into two variables, AFAP_DUM and UFAP_DUM. The AFAP_DUM variable is coded 1 if at least one FAP is affiliated with the current auditor of the company. This study assumes that the affiliation exists when there is existence of a past employment relationship between FAP and incumbent auditor. On the other hand, UFAP_DUM, captures those FAPs on the audit committee, who are not affiliated with the current auditor of the company. More specifically, the unaffiliated former audit firm partner does not have a past employment relationship with the current auditor. The FAPs were identified through the biographies in the annual reports and complemented by thorough web search.

I identify AFAP and UFAP by first using the biographies of directors that are presented in the annual reports. For instance, Air New Zealand Annual Report 2013 states:

" Roger France
BCOM, FCA
Appointed 1 October 2001
Mr France is a director of Fisher & Paykel Healthcare Corporation Limited, Chairman of Tappenden Holdings Limited and a member of the University of Auckland Council. He was a ***partner at PricewaterhouseCoopers*** *and one of its predecessor firms, Coopers & Lybrand, for over 15 years and was the Chief Financial Officer of two listed companies for 10 years. He was the Managing Partner of Coopers & Lybrand in Auckland for five years. Following the merger with PricewaterhouseCoopers, he led the firm's Corporate Value consulting practice in the Asia Pacific region and served as a member of its New Zealand Governance Board. Mr France brings strong financial analysis and business strategy skills to the Board and to his* ***role as Chairman of the Audit Committee****."* (Air New Zealand Limited 2013, p. 61).

The annual report mentions that the auditor is Deloitte (on behalf of the Auditor-General). Since Roger France does not have a prior employment relationship with Deloitte, Air New Zealand has an UFAP on its audit committee in 2013.

From the 2013 Auckland International Airport Limited Annual Report, I find that there is an AFAP on its audit committee. The director biography states that:

"Justine Smyth
BCom, CA
Justine Smyth was appointed a director of the company in 2012. Justine is currently a director of Telecom New Zealand Limited, a member of the Financial Markets Authority and chair of The New Zealand Breast Cancer Foundation.

Justine was previously deputy chair of New Zealand Post Limited and chair of its finance, audit, investment and risk committee. Justine's background also includes having been group finance director of Lion Nathan Limited and a ***partner of Deloitte.***

Justine is an owner and executive director of a clothing manufacture and wholesale business. Through her roles, Justine has strong experience in retail, governance, mergers and acquisitions, taxation and financial performance of large corporate enterprises, and the acquisition, ownership, management and sale of small and medium enterprises" (Auckland International Airport Limited 2013, p. 23).

A Google Search of this director also reveals that this FAP was a tax partner at Deloitte NZ between 1997 and 2000 (Global Women 2012).

The auditor of the company is Deloitte (Auckland International Airport Limited 2013, p. 129), which implies that the FAP shares a past employment relationship with the auditor. Therefore I code 1 for the AFAP_DUM variable.

There are companies, which do not have any FAP on its audit committee and board. For instance, in 2013, Briscoe Limited had four directors on its board, of which three were on the audit committee. However, none of these directors have experience as FAP.

There was no biography of directors but a web search assisted in obtaining information. From Briscoe Limited's corporate website, I obtain the following biographies:

"1. Dame Rosanne Philippa O'Loghlen Meo

Chairman (Non-Executive)

Dame Rosanne Meo has been a director and Chairman of Briscoe Group Limited since May 2001. She also chairs the Group's Human Resources Committee.

Rosanne is Chairman of the Auckland Philharmonia Orchestra, The Real Estate Institute and AMP Services (NZ). She is also a director of Overland Footwear and James Dunlop Textiles and a Trustee of the Kelliher Trust and the South Auckland Health Foundation.

In the 2012 New Year Honours List Rosanne became a Dame for services to business.

2. Rodney Adrian Duke

Group Managing Director and Deputy Chairman

Rod Duke has spent all his working life in the retail sector. After leaving school in Adelaide, he commenced work with retailers in South Australia before moving to Waltons in Sydney in 1980. From 1981 to 1988 he held the positions of New South Wales Manager of Homecraft / Eric Anderson Stores, a senior merchandise executive for Grace Brothers then Managing Director of Norman Ross.

In September 1988, Rod was appointed Managing Director of Briscoes (New Zealand) Limited, at that time a subsidiary of Hagemeyer of the Netherlands, with a mandate of returning the company to profitability and preparing it for sale. In January 1990, Rod reached agreement for the RA Duke Trust to purchase 100% of the shares of Briscoes.

In 1996 Rod established, and in subsequent years expanded, the Rebel Sport chain of sporting goods stores in New Zealand as a business within the Briscoe Group.

Briscoe Group issued shares to the public in 2001 and listed on the New Zealand Stock Exchange. The RA Duke Trust continues as the Group's majority shareholder.

Rod is also a non-executive director of Pumpkin Patch.

3. Alaister John Wall

Executive Director

Alaister joined Briscoes (New Zealand) Limited in 1970.

During more than four decades with the Group, he has held a variety of accounting and administration positions before being appointed Group Accountant in 1981, Finance Director and Company Secretary in 1987 and Deputy Managing Director in 2001. From 1987 to 2002 Alaister managed the legal, financial accounting and financing functions of the Group, including the expansion of the network of Briscoes stores, the establishment and development of Rebel Sport into the New Zealand market and the restructure of the Group in preparation for the public Share offer and In 2002 he was appointed Deputy Managing Director.

Alaister actively contributes on behalf of the Group to a wide range of community support activities including being on the Board of Cure Kids, our charity of choice, and overseeing the Briscoe Group Scholarship set up to encourage tertiary level study for eligible employees and their children.

4. Stuart Hamilton Johnstone

Director (Non-Executive)

Stuart Johnstone was appointed as a non-executive director of Briscoe Group Limited in May 2001 following completion of an advisory mandate to assist with the transition of the Group to become publicly listed on the New Zealand Stock Exchange. Stuart also chairs the Group's Audit Committee.

Stuart has a background in life office investment management and investment banking, including periods as a principal of Buttle Wilson sharebrokers, and as an investment banker with Fay Richwhite. He has managed many dozens of mergers and acquisitions, capital raisings and initial public offerings including the initial public offer of shares by Telecom as a member of the Fay Richwhite team.

He has held directorships in a variety of companies over the last 25 years, and continues to provide investment banking and financial advisory services to corporate

clients. Stuart is also the joint owner-operator of a website development business." (Briscoe Limited, 2015).

Therefore, the FAP_DUM, AFAP_DUM and UFAP_DUM are coded 0 for Briscoe Limited in 2013.

In the 2013 Annual Report of Kathmandu Holdings Limited, the director biographies suggest that a FAP is on the board and audit committee.

*" **John Harvey, Chairman***

*Mr Harvey is a professional Director with a background in accounting and professional services, including 23 years as a **partner of PricewaterhouseCoopers** where he also held a number of leadership and governance roles. Mr Harvey has extensive experience in financial reporting, governance, information systems and processes, business evaluation, acquisition, merger and takeover reviews.*

Mr Harvey is currently a non-Executive Director of DNZ Property Fund, Heartland Bank, Ballance Agri-Nutrients, Port Otago and NZ Opera" (Kathmandu Holdings Limited 2013, p. 12).

The annual report also mentions that John Harvey is the chairman of the audit committee and the audit report is signed by PricewaterhouseCoopers. This means that John Harvey is an AFAP.

These independent variable measures are consistent with studies by Naiker et al. (2013) and Naiker and Sharma (2009), who also employ dichotomous variables to capture the presence of former audit firm partners on the audit committee. Consistent with the hypotheses, I expect FAP_DUM and AFAP_DUM to have a positive relationship with NAS but UFAP_DUM to have a non-significant positive or significant negative association with NAS.

4.4.2 Expertise Variables: Controlling the Presence of Other Experts on the Audit Committee

Consistent with Naiker et al. (2013), a number of expertise control variables are also included in the regression model to control for other audit committee expertise, which can affect the relationship between FAPs and NAS fees. As mentioned, former

audit firm partner is one type of expert, who can serve on an audit committee. However, other experts can also be present on the audit committee to influence audit committee decisions, including the purchase of NAS from the auditor. To control for other experts that may be present on the audit committee, the model includes three dichotomous variables, OTHER_ACCTG_DUM, FINANCE_DUM and SUPER_DUM. Each of these three variables represents different experts on the audit committee and follows Naiker et al. (2013). The variable OTHER_ACCTG_DUM is coded 1 if there is at least one member of the audit committee who possesses accounting or auditing expertise but is not a former audit firm partner, and 0 otherwise. Examples of such experts include chartered accountants, chief financial officers or possess experience from other major accounting positions. The second variable, FINANCE_DUM, is coded 1 if at least one member of the audit committee has work experience as an investment banker, venture capitalist, financial analyst or in other financial management roles, and 0 otherwise. The third variable, SUPER_DUM, which controls for the presence of supervisory experts on the audit committee, is coded 1 if at least one member of the audit committee has work experience as chief executive officers and 0 otherwise.

All the members of the audit committee were categorised into the different expertise variables using the biographies found in the publicly available annual reports. These were complemented by thorough web searches.

In 2013, the Auckland International Airport Limited had three other experts on its audit committee, who were identified using the biographies presented in the annual report.

"James Miller, BCom, FCA, AMinstD

James Miller was appointed a director of the company in 2009. He is the ***chair of Auckland Airport's audit and financial risk committee****.*

James has spent 14 years working in the share-broking industry. During this time, he has specialised in the strategy and valuation of airport and utility companies. Specifically, he had a leading role in the valuation and global pre-marketing of Auckland Airport and Beijing Capital International Airport and of Contact Energy Limited and Vector Limited initial public offers.

*James is a **qualified chartered accountant and is a Fellow of the New Zealand Institute of Chartered Accountants**, a Certified Securities Analyst Professional, a member of the New Zealand Institute of Directors and is a graduate of the Advanced Management Program at Harvard Business School (USA). James is deputy chair of NZX Limited, a member of the Financial Markets Authority, and a director of Accident Compensation Corporation and Mighty River Power Limited"* (Auckland International Airport Limited 2013, p.23).

Since James Miller is a qualified chartered accountant, the OTHER_ACCTG_DUM variable is coded 1.

"John Brabazon, BCom, ACA, AFInstD, F FIN

John Brabazon was appointed a director of the company in 2007.

*He graduated in commerce from The University of Auckland and is an executive director of **merchant bankers** Clavell Capital Limited. He has approximately 30 years' **experience in the capital markets**.*

John is also a governing member of Round Mountain Oil, LLC in the USA.

*He is a member of the New Zealand Institute of Chartered Accountants, an Accredited Fellow of the Institute of Directors in New Zealand (Inc), a Fellow of the Financial Services Institute of Australasia and is a **Certified Finance and Investment Professional with the Institute of Finance Professionals New Zealand Inc**."* (Auckland International Airport Limited 2013, p. 22).

John Brabazon possesses merchant banking experience and capital markets experience, therefore FINANCE_DUM is coded 1.

Supervisory experts possess experience from serving on senior management positions at companies. Auckland International Airport Limited also had such experts on its audit committee in 2013. For instance,

"Keith Turner Deputy Chair, BE (Hons), ME, PhD, FIEE, Dist. FIPENZ, MInstD

Keith Turner was appointed a director of the company in 2004 and deputy chair in 2007. He is the chair of Auckland Airport's human resources, nominations, and safety and operational risk committees.

He has 39 years' experience in the New Zealand electricity industry, the last 21 years of which have been spent in ***senior executive positions****.*

Keith has participated in widespread reform of the industry, both in industry review teams and acting for the Government on a range of industry boards.

In 1999, he took up the position of ***chief executive*** *of Meridian Energy Limited following the breakup of Electricity Corporation of New Zealand Limited, a role from which he retired in 2008.*

He has an extensive track record in creating value from infrastructure with a particular focus on identifying market opportunities, strategic analysis, large capital project development and execution, organisational culture and large-scale operations.

Keith is also chair of Fisher & Paykel Appliances Limited and Solar City Limited and a director of Chorus Limited and Spark Infrastructure Limited" (Auckland International Airport Limited 2013, p. 22). Therefore, SUPER_DUM is coded 1.

4.4.3 Control Variables

It is also important to control for the size, independence, and diligence of the audit committee because it could influence NAS purchase decisions and is well captured in prior literature (Abbott et al. 2003a; Lee and Mande 2005; Naiker et al. 2013).

First, the variable, ACSIZE, is measured as the number of members on the audit committee. Prior studies (Vafeas 2003; Sharma et al. 2009; Naiker et al. 2013) postulate that a larger audit committee is associated with better monitoring of the financial reporting process. Moreover, a larger audit committee implies better resources to manage financial reporting process. This also implies that the audit committee may not require auditor to provide NAS. However, a larger audit committee may purchase more NAS if free rider problems exist (Vafeas 2003; Sharma et al. 2009; Naiker et al. 2013). If members of the audit committee do not contribute effectively to the decision making process and monitoring of the financial reporting process, the large audit committee becomes ineffective. As a result, no expected sign is postulated for ACSIZE.

Second, the independence of the audit committee is another important determinant of NAS fees. Independent audit committee members are concerned with their reputational capital and future employment (Abbott et al. 2003a). As a result, the independent directors effectively monitor the financial reporting process and reduce threats to auditor independence. Thus, a negative coefficient is expected on the ACIND variable. ACIND is measured as the number of independent audit committee members. Prior studies such as Hay et al. (2008) and Sharma and Kuang (2014) employ this measure of audit committee independence for New Zealand companies.

Third, the number of audit committee meetings, (LNAC_MEET), is another important characteristic of an effective audit committee. However, no expectation is formed because the number of meetings can indicate a proactive or a reactive audit committee (Naiker et al. 2013). If the audit committee meets often, it may indicate that the committee is efficient and actively monitoring the financial reporting process. It can also indicate that the audit committee is trying to resolve problems that may have arisen during the financial reporting process. The variable is measured as the natural logarithm of annual audit committee meetings and no expected sign is posited.

Board governance variables are also included to control for its effects on NAS fees. Audit committees are a subset of the board and part of the corporate governance framework of the company. BODSIZE, BODIND and LNBOD_MEET variables are also included in the regression model. BODIND is negatively associated with NAS fees because independent board members seek to protect their reputational capital and demand fewer NAS from the auditor (Naiker et al. 2013). However, no direction is postulated for LNBOD_MEET (measured as the natural logarithm of the number of board meetings in the year) and BODSIZE (measured as the number of directors on the board) because a board that meets often may indicate proactive or a reactive board. A larger board may indicate more resources to monitor the financial reporting process or indicate ineffective monitoring because of free rider problems.

CEO_DUALITY variable captures whether the board chairman and the chief executive officer is the same person. Dechow et al. (1996) and Sharma (2004) argue that if the roles of the CEO and the board chairman are not separated, then the

likelihood of earnings management increases. If the CEO also acts as the board chairman, then there is a high risk that the CEO will hide certain information from the board and prevent other directors from contributing effectively to the financial reporting process of the company. The CEO with its dual role is able to weaken the board and then tries to influence the auditor from overlooking financial misstatements. By purchasing more NAS, the CEO creates an economic dependence, which it exploits to influence auditor's independent judgment in financial statement audits. A positive association is expected because the CEO/Chairman would approve more NAS to create economic dependence for the auditor (Beasley 1996; Sharma 2004; Naiker et al. 2013).

To control for Big 4 audit firms (Frankel et al. 2002; DeFond et al. 2002; Naiker et al. 2013), the model includes a dichotomous variable, BIG4. The variable is coded 1 if the current auditor is either PricewaterhouseCoopers, KPMG, Ernst & Young or Deloitte and 0 otherwise. Another variable, LOSS, is included to indicate if the firm makes a loss in a particular year. Company losses are expected to decrease the purchase of NAS because firms are not able to afford it (Naiker et al. 2013).

Financial leverage (LEV), book-to-market ratio (BM_RATIO), annual return (ANNRET), companies with new auditor (INITIAL) are all negatively associated with NAS fees (Frankel et al. 2002; DeFond et al. 2002; Naiker et al. 2013). These studies also mention that larger firms (LN_ASSETS), companies with foreign operations (FOROPS), employment plans (EMPLAN), acquisition or merger (MERGER), restructuring costs (RESTR), change in debt (DEBTCHANGE_DUM) and growing firms (SALES_GROWTH) are all expected to be positively associated with NAS fees. Table 4.1 presents and summarises the variable definitions, source of the data for these measures and relevant studies that use these measures.

TABLE 4.1

Variable Definitions

Panel A: Main Dependent Variable and Alternative Dependent Variables

Variable Name		Variable Measurement (Source)	Relevant Study
FEERATIO	=	proportion of NAS fee over total fees paid to the auditor (i.e. Sum of audit fee and NAS fees)	Craswell (1999) Frankel et al. (2002) Gul et al. (2006) Naiker et al. (2013)
LNNAF	=	natural logarithm of NAS fees paid to the auditor	Ashbaugh et al (2003) Whisenant (2003) Naiker et al. (2013)
NAS_AF	=	ratio of NAS fees to audit fees	Srinidhi and Gul (2007) Basiouidis et al. (2008) Naiker et al. (2013)

UNEXP_NAF	=	Unexpected portion of the natural logarithm of NAS fees. This is derived by regressing the LNNAF model with all independent variables in Panel D. The residuals of this regression form the unexpected portion of the NAS fees	Naiker et al. (2013)
		Panel B Main Independent Variables	
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
FAP_DUM	+	1 if at least one member of the audit committee is a former audit firm partner, and otherwise 0 (web search and annual reports)	Naiker et al. (2013)
AFAP_DUM	+	1 if at least one member of the audit committee is a former audit firm partner and shares a past employment relationship with the current auditor, and otherwise 0 (web search and annual reports)	Naiker et al. (2013)
UFAP_DUM	-	1 if at least one member of the audit committee is a former audit firm partner and does not share a past employment relationship with the current auditor, and otherwise 0 (web search and annual reports) *The study uses previous employment of the former audit firm partner to determine affiliation*	Naiker et al. (2013)

Panel C: Expertise Control Variables			
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
OTHER_ACCTG_DUM	-	1 if the audit committee has a member who has experience as certified practising accountant, chief financial officer or other major accounting positions, and otherwise 0 (web search and annual reports)	Naiker et al. (2013)
FINANCE_DUM	-	1 if the audit committee has a member who has experience as financial analyst, venture capitalist, or other major financial management positions and otherwise 0 (web search and annual reports)	Naiker et al. (2013)
SUPER_DUM	-	1 if the audit committee has a member who has experience as chief executive officer and otherwise 0 (web search and annual reports)	Naiker et al. (2013)

Panel D: Other Control Variables			
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
ACSIZE	?	Number of members of the audit committee (annual report)	Naiker et al. (2013)
ACIND	-	Number of independent members on the audit committee (annual report)	Hay et al. (2008) Sharma and Kuang (2014)
LNAC_MEET	?	Natural logarithm of the number of audit committee meetings in a year (annual report)	Naiker et al. (2013) Sharma and Kuang (2014)
BODSIZE	?	Number of directors on the board (annual report)	Sharma and Kuang (2014)
BODIND	-	Number of Independent board members (annual report)	Sharma and Kuang (2014)

Panel D: Other Control Variables (cont'd)			
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
LNBOD_MEET	?	Natural logarithm of the number of board meetings in a year (annual report)	Naiker et al. (2013)
BIG4	+	1 if the firm employs a Big 4 auditor, and otherwise 0 (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
INITIAL	-	1 if the auditor is in the first two years of the engagement, otherwise 0	Naiker et al. (2013)
CEO_DUALITY	+	1 if the Chief Executive Officer and the Board Chairman is the same person, and otherwise 0 (annual report)	Beasley (1996) Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
SALES_GROWTH	+	Percentage change in sales from previous year (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)

Panel D: Other Control Variables (cont'd)			
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
DEBTCHANGE_DUM	+	1 if the company issued debt in a year (i.e. There is at least a 5 percent change in debt), and otherwise 0 (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
LEV	-	Proportion of total liabilities over total assets (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
LN_ASSETS	+	Natural logarithm of total assets (annual reports)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
LOSS	-	1 if the company incurred a loss, and otherwise 0 (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)

Panel D: Other Control Variables (cont'd)			
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
BM_RATIO	-	book-to-market ratio (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
ANNRET	-	Percentage change in share price over previous period (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
FOROPS	+	1 if the company has foreign operations or transactions, and otherwise 0 (annual report)	Frankel et al. (2002) Naiker et al. (2013)
MERGE	+	1 if the company was involved in a merger or acquisition, and otherwise 0 (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)

Panel D: Other Control Variables (cont'd)			
Variable Name	**Expected Sign**	**Variable Measurement (Source)**	**Relevant Study**
EMPLAN	+	1 if the company has a post-retirement plan for its employees, and otherwise 0 (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)
RESTR	+	1 if the company was involved in a restructure of operations, and otherwise 0 (annual report)	Frankel et al. (2002) DeFond et al. (2002) Naiker et al. (2013)

Other control variables in additional analyses are defined and presented with the respective results.

4.5 Sample

This thesis examines the association between the presence of former audit firm partners on audit committees and NAS fees in New Zealand. The sample consists of companies listed on New Zealand Stock Exchange between 2004 and 2013.

The data has been hand collected from publicly available annual reports of 108 unique companies (or 980 firm-year observations). Nearly all the companies listed on the New Zealand Stock Exchange constitute the sample for this study and represent various industries that exist in New Zealand. Table 4.2 summarises the steps used to select the sample for the study.

TABLE 4.2

Sample Selection

Number of unique companies from the New Zealand Stock Exchange	**108**
Number of firm-year observations expected (108 companies x 10 years)	1080
Less firm-year observations with missing data because it closed operations during the sample period	43
Less firm year observations with missing data because it became publicly listed later in the sample period	52
Less firm-year observations with missing information	5
Final Sample	**980**

The benefit of hand collecting data is that the risk of missing observations is low, which is very important for the New Zealand setting. New Zealand has a stock exchange with around 160 companies listed on it. The reason for beginning the sample period in 2004 is because it is after SOX was introduced in the U.S. that banned the purchase of most NAS from auditors, and SEC approved the cooling-off rule for FAPs. A lapse of two years would provide sufficient time for other countries to follow the U.S. and firms around the world may voluntarily implement processes or reduce purchase of NAS to appease capital markets. A second reason for beginning the sample in 2004 is because of data availability; electronic annual

reports available online do not go back too far. Companies tend to keep up to 10 years of annual report information on their websites in New Zealand.

Since the dataset is both cross-sectional and time series, it becomes a panel data set. A panel data set allows the use of regression analysis and improves external validity of the results. However, using time series data can create complications relating to time effects. To counter effects of the potential problem, the model also includes year dummy variables. Since the companies represent various industries that may exhibit unique characteristics, the model also includes industry dummy variables.

Finally, necessary adjustments and measurements were made to remove skewness from the data. The presence of skewness implies that data does not behave like a normal distribution. Skewness describes the balance of the distribution on left and right side (Hair et al. 2006) and is solved by transforming data into square root, natural logarithm, squared or cubed values (Hair et al. 2006). I transformed NAS fees (LNNAF), audit committee meetings (LNAC_MEET), board meetings (LNBOD_MEET and total assets (LN_ASSETS) to remove skewness from the observations.

4.6 Statistical Tests and Sensitivity Analyses

The following additional analyses are also employed to test sensitivity and robustness of the main results.

1. Different measures of the dependent variable were used to test the hypotheses.
   For example, replacing FEERATIO with (1) natural logarithm of NAS fees (LNNAF), (2) NAS fee to audit fee ratio (NAS_AF), and (3) Unexpected non audit fees (UNEXP_NAF). Unexpected NAS fee is the residual derived by regressing natural logarithm of NAS fee (LNNAF) on all control variables in Panel D of Table 4.1.

2. Using percentage as a measure of the independent variables, FAP, AFAP and UFAP. For example, FAP_PER is the proportion of the audit committee with FAPs.

3. As described in the previous chapter, the literature on NAS fees is divided into two perspectives. One stream argues that the joint provision of NAS and audit services creates independence threats for the auditor, which is subsequently associated with earnings management. The other stream argues that joint provision can generate knowledge spillover benefits, which can assist the auditor to conduct an efficient and a higher quality audit.

   To test these propositions we employ an audit lag model used by Tanyi, Raghunandan and Barua (2010), Knechel, Sharma and Sharma (2012) and Knechel and Sharma (2012). The study also uses the Sharma and Kuang (2014) aggressive earnings management model to examine if NAS purchases are associated with auditor independence problems. If FAPs are positively associated with earnings management then it implies that the presence of FAP is not beneficial. An association with shorter audit lag will indicate that the FAP's decision to purchase NAS creates knowledge spillover benefits.

4. The study also uses an audit fee model to test whether FAPs affect the financial statement audit process of companies. As discussed earlier, if the FAP is associated with an impairment of auditor independence, then it may indicate low audit quality. Some studies use audit fees to capture audit quality. This study tests whether the FAP may negotiate a reduction in audit fee to influence audit quality (Naiker et al. 2013).

4.7 Summary and Conclusions

This chapter described the research design of this study. It described methods employed to test the hypotheses developed in the preceding chapter. The chosen model is an Ordinary Least Squares regression. A description of the sample and sensitivity tests was also presented in this chapter. The next chapter presents the results from the tests described in this chapter.

CHAPTER 5: FORMER AUDIT PARTNER AND NON AUDIT SERVICES IN NEW ZEALAND: RESULTS

5.1 Introduction

This chapter presents the results of the statistical tests and analyses described in the previous chapter of this thesis. The results indicate that former audit firm partners do not purchase significantly higher NAS. However, after the FAP variable is separated into affiliated FAP and unaffiliated FAP, the results become clearer. AFAPs are associated with higher NAS while UFAPs are associated with lower NAS. Higher NAS purchases may indicate either knowledge spillover benefits or auditor independence problems.

To ascertain this, additional tests are conducted using the audit lag model (proxy for knowledge spillover benefits) and aggressive earnings management model (proxy to test for possible auditor independence issues). The results from these two additional analyses indicate an interaction between NAS, FAP and the proxies (aggressive earnings management and knowledge spillover). Firms where AFAPs serve on the audit committee and approve high NAS, have (i) longer audit lag and are (ii) more likely to exhibit aggressive earnings management.

These findings are corroborated by the audit fee test, which shows that AFAPs are negatively associated with audit fees. Other sensitivity analyses also indicate that the main results continue to hold. The next section of the chapter presents and discusses the results including implications for the accounting profession and the regulators.

5.2 Summary Statistics

5.2.1 Full Sample Summary Statistics

Table 5.1 presents a summary of the descriptive statistics, which includes the mean, median, standard deviation, upper and lower quartile values of the full sample. The average (median) values for FAPs, AFAPs and UFAPs on audit committees are 0.27, 0.06 (0), and 0.21 (0), respectively. This implies that there are close to 265, 59, and 206 firm-year FAP, AFAP and UFAP observations in the sample. Interestingly, the

proportion of AFAPs to UFAPs in the sample here is similar to Naiker et al. (2013); their proportion of AFAPs to UFAPs is 27.4% and here it is 28.6%. FEERATIO is also similar between this study and Naiker et al. (2013).

The summary statistics for variables, which are included to control the effects of other audit committee experts suggest that 44 percent of the audit committees in the sample comprise of at least one other accounting expert (OTHER_ACCTG_DUM = 0.44, median 0.00). In addition, 30 percent of the sample comprise of at least one member with financial management experience (FINANCE_DUM = 0.30, median = 0.00), and 82 percent of the audit committees in the sample have at least one member with supervisory experience (SUPER_DUM = 0.82, median = 1.00).

The average audit committee size (ACSIZE) is 3.26 (median = 3.00), implying that majority of the companies comply with the NZX Listing Rule 3.6 requirement of having at least three directors on an audit committee. The lower quartile value also supports this argument. On average, an audit committee comprises of 2.53 independent directors (ACIND = 2.53, median 2.00). Majority of the audit committees are independent implying compliance with Rule 3.6 and the NZ Corporate Governance Code.

An average audit committee met for 3.66 times during the year (LNAC_MEET = 1.30, median 1.10). Overall, the summary results imply that majority of the audit committees comply with the requirements established by NZX Listing Rule 3.6 and the Corporate Governance Handbook issued by the FMA. Following this summary finding, it becomes even more interesting to examine how FAP, AFAP, and UFAP will affect NAS purchases of a company in a natural setting.

The average (median) size of the board is 5.85 (6.00), of which 3.60 directors are independent (median = 3.00). The values for BODIND suggest that many company boards include independent directors merely to comply with the independence requirements of the audit committee; the BODIND summary statistics map closely with the audit committee independence summary statistics. An average NZ company board met for at least 9.97 times annually (LN_BODMEET mean = 2.30, median = 2.40).

TABLE 5.1

Sample Descriptive Statistics

Full Sample

n=980

Variable	Mean	Median	Standard Deviation	Lower Quartile	Upper Quartile
FEERATIO	0.23	0.20	0.20	0.01	0.38
FAP	0.27	0.00	0.44	0.00	1.00
AFAP_DUM	0.06	0.00	0.23	0.00	0.00
UFAP_DUM	0.21	0.00	0.41	0.00	0.00
OTHER_ACCTG_DUM	0.44	0.00	0.50	0.00	1.00
FINANCE_DUM	0.30	0.00	0.46	0.00	1.00
SUPER_DUM	0.82	1.00	0.38	1.00	1.00
ACSIZE	3.26	3.00	1.24	3.00	4.00
ACIND	2.53	2.00	1.19	2.00	3.00
LNAC_MEET	1.30	1.10	0.42	1.10	1.61
BODSIZE	5.85	6.00	1.50	5.00	7.00
BODIND	3.60	3.00	1.63	2.00	5.00
LN_BODMEET	2.30	2.40	0.46	2.20	2.48
BIG4	0.84	1.00	0.37	1.00	1.00
INITIAL	0.12	0.00	0.33	0.00	0.00
CEO_DUALITY	0.07	0.00	0.48	0.00	0.00
LOSS	0.22	0.00	0.41	0.00	0.00
SALES_GROWTH	0.61	0.06	6.32	-0.03	0.18
DEBTCHANGE_DUM	0.66	1.00	0.48	0.00	1.00
LEV	0.63	0.44	3.96	0.30	0.61
LN_ASSETS	18.73	18.95	2.31	17.38	20.37
BM_RATIO	0.89	0.62	4.18	0.27	1.08
ANNRET	0.06	0.00	0.57	-0.17	0.17
FOROPS	0.83	1.00	0.38	1.00	1.00
EMPLAN	0.10	0.00	0.30	0.00	0.00
MERGE	0.15	0.00	0.36	0.00	0.00
RESTR	0.13	0.00	0.33	0.00	0.00

Summary results on other control variables indicate that 84 percent of the companies are audited by Big 4 audit firms (BIG4 = 0.84). The INITIAL variable indicates that there are 118 firm-year observations where auditors are in the first or second year of the audit engagement (INITIAL mean = 0.12). The average proportion of companies, where the CEO serves as board chairman is seven percent (CEO_DUALITY = 0.07).

The average debt-to-asset (LEV) ratio is 0.63, indicating that companies in New Zealand rely mostly on debt financing. Moreover, the DEBTCHANGE_DUM indicates that 66 percent of the companies, reported a significant change in the value of liabilities over the past year. The size of the company is measured by total assets. The average size of companies in the sample is $136,249,728 NZD (LN_ASSETS = 18.73).

The average sales growth rate is 61 percent (SALES_GROWTH = 0.61). The mean book-to-market ratio (BM_RATIO) is 0.89 and the average market return (ANNRET) is 0.06. The average values for FOROPS, EMPLAN, MERGE and RESTR are 0.83, 0.10, 0.15 and 0.13, respectively. The FOROPS result suggests that majority of the companies have foreign subsidiaries or operations.

5.2.2 FAP and Non-FAP Sample Summary Statistics

Table 5.2 presents summary statistics and independent samples t-test, after the full sample is split into FAP and non-FAP subsamples. The two subsamples reveal that there are 264 observations in sample, which capture the presence of FAPs on audit committees. Twenty percent (or 53 former audit partner observations) are AFAPs and share a past employment relationship with the incumbent auditor of the company. The remaining observations (or 211 observations) indicate the presence of UFAPs on the audit committees.

There are three expertise variables and two (OTHER_ACCTG_DUM and SUPER_DUM) have statistically significant differences. The sample descriptive results show that the mean values of the OTHER_ACCTG_DUM variable is 0.48 for the non-FAP sample and 0.34 for companies with a FAP on audit committees. The difference is significantly different and similar to the findings in Naiker et al. (2013).

The FINANCE_DUM variable mean is 0.30 for the non-FAP sample and 0.31 for the FAP sample. Again, this is similar to the evidence in Naiker et al. (2013). The third expertise variable, SUPER_DUM, implies that there are more supervisory experts on audit committees when FAPs are also present on audit committees. As an overall comparison to the full sample, there are more supervisory experts on audit committees (SUPER_DUM mean = 0.82) when compared to other experts (OTHER_ACCTG_DUM mean = 0.44 and FINANCE_DUM mean = 0.30) in New Zealand. The relative presence of supervisory experts to other accounting and finance experts is also similar to Naiker et al. (2013). Overall, the very similar accounting expertise summary statistics for the audit committee between this study and Naiker et al. (2013) suggests reliability in the data procedures of this study.

On average, NZ audit committees with FAP have 3.63 members, of which 2.98 members are independent. The audit committees meet for an average of 4.1 times annually (LNAC_MEET = 1.42). Moreover, summary descriptive results on other governance control variables indicate differences between firms with and without FAPs. The average size of the audit committee without FAP is 3.13 and has 2.37 independent members. However, a larger audit committee does not necessarily indicate its effectiveness. A large audit committee can imply greater resources for monitoring the financial reporting process or it can indicate free rider problems. Only a few members may be actively involved in effectively monitoring the financial reporting process.

Similar results are also observed for board governance variables. Boards with FAPs are larger (BODSIZE mean = 6.26) and more independent (BODIND mean = 4.27) as compared to companies, which do not have FAPs (BODSIZE mean = 5.70; BODIND mean = 3.35). However, there is no significant difference for the board meetings variable.

There are more Big 4 auditors for companies with FAPs (BIG4 = 0.89) as compared to companies without FAPs (BIG4 = 0.83). Interestingly, only the non-FAP sample has companies where the CEO is also the board chairman (CEO_DUALITY = 0.09).

The LOSS variable indicates that 15 percent of the companies in the FAP subsample made losses while 25 percent made losses in the non-FAP sample. The companies' sales growth in both subsamples is not statistically different. The average debt-to-asset (LEV) ratio does not have statistical difference between the two subsamples. Moreover DEBTCHANGE_DUM also suggests that there is no statistical difference between the two subsamples. The size of the company is measured by total assets. The average size of companies with FAPs is $ 325,215,956 NZD (LN_ASSETS = 19.60) while it is $98,937,609 NZD (LN_ASSETS = 18.41) for the non-FAP sample. The ANNRET, FOROPS and BM_RATIO are not statistically different for both subsamples. The average values of EMPLAN, MERGE and RESTR are 0.17, 0.19, and 0.19 respectively for the FAP subsample, and 0.07, 0.14, and 0.10 for the non-FAP subsample.

Table 5.3 presents the correlation coefficients of the control and test variables. All, except one, coefficients are below 0.80 threshold implying that multicollinearity is not a problem. The highest coefficient is 0.817. The Variance Inflation Factor (VIF) is also calculated and the highest VIF is 5.9. All VIF values are below the threshold of 10 (not tabulated). This suggests that multicollinearity issues do not threaten the results (Hair et al. 2006).

TABLE 5.2

Sample Descriptive Statistics

	Non-FAP Sample n=716			FAP Sample n=264			Test of Differences
Variable	**Mean**	**Median**	**Standard Deviation**	**Mean**	**Median**	**Standard Deviation**	**t statistic**
FEERATIO	0.23	0.20	0.20	0.22	0.21	0.19	0.60
AFAP_DUM	-	-	-	0.20	0.00	0.40	
UFAP_DUM	-	-	-	0.80	1.00	0.40	
OTHER_ACCTG_DUM	0.48	0.00	0.50	0.34	0.00	0.48	3.82***
FINANCE_DUM	0.30	0.00	0.46	0.31	0.00	0.46	-0.27
SUPER_DUM	0.80	1.00	0.40	0.88	1.00	0.32	-2.96***
ACSIZE	3.13	3.00	1.29	3.63	3.00	1.01	-5.78***
ACIND	2.37	2.00	1.11	2.98	3.00	1.27	-7.40***
LNAC_MEET	1.26	1.10	0.42	1.42	1.39	0.38	-5.33***
BODSIZE	5.70	6.00	1.45	6.26	6.00	1.55	-5.28***
BODIND	3.35	3.00	1.47	4.27	4.00	1.85	-8.12***
LN_BODMEET	2.30	2.40	0.46	2.29	2.40	0.47	0.51
BIG4	0.83	1.00	0.38	0.89	1.00	0.32	-2.32**

TABLE 5.2 (continued)

Sample Descriptive Statistics

	Non-FAP Sample n=716			FAP Sample n=264			Test of Differences
Variable	**Mean**	**Median**	**Standard Deviation**	**Mean**	**Median**	**Standard Deviation**	**t statistic**
INITIAL	0.13	0.00	0.33	0.11	0.00	0.32	0.51
CEO_DUALITY	0.09	0.00	0.56	0.00	0.00	0.00	2.58***
LOSS	0.25	0.00	0.43	0.15	0.00	0.36	3.17***
SALES_GROWTH	0.71	0.05	7.27	0.32	0.06	2.23	0.84
DEBTCHANGE_DUM	0.66	1.00	0.47	0.65	1.00	0.48	0.34
LEV	0.71	0.47	4.64	0.42	0.41	0.20	1.03
LN_ASSETS	18.41	18.52	2.32	19.60	19.60	2.05	-7.39***
BM_RATIO	0.91	0.57	4.87	0.84	0.76	0.68	0.23
ANNRET	0.07	0.00	0.62	0.05	0.00	0.42	0.58
FOROPS	0.83	1.00	0.37	0.82	1.00	0.39	0.52
EMPLAN	0.07	0.00	0.26	0.17	0.00	0.38	-4.51***
MERGE	0.14	0.00	0.35	0.19	0.00	0.39	-1.72*
RESTR	0.10	0.00	0.30	0.19	0.00	0.39	-3.61***

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

5.3 Multivariate Results

5.3.1 Test of H1

Table 5.4 reports results from the multivariate analysis, which tests the first hypothesis of the study. The model is significant as indicated by the F statistic (4.057, p-value < 0.001). The adjusted r-square is 0.118 and is comparable to Naiker et al. (2013), who report an adjusted r-square of 0.057.

Hypothesis 1 presented a null association between FAPs and NAS purchases because of alternative arguments. However, the test variable, FAP_DUM, has a negative but insignificant association with FEERATIO (p-value = 0.35). This result indicates that the presence of a FAP on the audit committee is not associated with NAS purchases relative to total fees paid to the firm's auditor. Therefore, this finding cannot reject the null effect in H1.

Results on the expertise variables indicate that OTHER_ACCTG_DUM is not significant. However, FINANCE_DUM is significantly and positively ($\beta = 0.031$, p-value = 0.038) associated with FEERATIO, while SUPER_DUM ($\beta = -0.042$, p-value 0.013) is negatively associated with FEERATIO. These results imply that supervisory experts purchase fewer NAS while finance experts purchase more NAS from the auditor.

Moreover, the ACIND coefficient is -0.038 (p-value = 0.001) implying a negative and significant relationship with the FEERATIO. The number of audit committee meetings (LNAC_MEET $\beta = -0.037$, p-value = 0.030) is also significant and negatively associated with the dependent variable (FEERATIO). Prior studies argue that the number of audit committee meetings and audit committee independence measure the effectiveness of audit committee. The negative coefficient on ACIND implies that independent directors strive to protect their reputational capital and avoid litigation risk to maintain future opportunities for employment as directors, hence they purchase fewer NAS. The negative coefficient on LNAC_MEET indicates that audit committees that meet more often (more diligent) are related to fewer NAS purchases from the incumbent auditor.

The BIG4 variable (β = 0.081, p-value < 0.001) has a positive coefficient and is significantly associated with FEERATIO. As expected, Big 4 audit firms provide a better quality of services and are expected to charge higher fees than the non-big 4 audit firms (Frankel et al. 2002; Naiker et al. 2013).

The size of the firm, LN_ASSETS, (β = 0.014) is positive and significantly (p-value = 0.002) associated with FEERATIO. Larger companies are more complex, and thus, may require more quantity of NAS from the auditor (Naiker et al. 2013).

The INITIAL variable is negative and significantly associated (β = -0.040, p-value = 0.022) with FEERATIO. This finding suggests that the companies do not purchase more NAS from the new auditor. However, the companies may purchase more NAS as they become familiar with the auditor and the quality of the services.

The FOROPS variable (β = 0.032, p-value = 0.048) is significant and positively associated with FEERATIO. The existence of foreign operations/transactions suggests more complex operations, and thus, requires more NAS. Other control variables LOSS, SALES_GROWTH, LEV, BM_RATIO, ANNRET, MERGE, RESTR, EMPLAN, ACSIZE, BODSIZE, BODIND, OTHER_ACCTG_DUM, CEO_DUALITY are insignificant and presented in Table 5.4.

TABLE 5.3
Pearson Correlation Coefficients

Variable		(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
FAP_DUM	**(1)**	1								
AFAP_DUM	**(2)**	0.398***	1							
UFAP_DUM	**(3)**	0.860***	-0.126***	1						
OTHER_ACCTG_DUM	**(4)**	-0.121***	-0.081**	-0.086***	1					
FINANCE_DUM	**(5)**	0.009	-0.053*	0.039	-0.082**	1				
SUPER_DUM	**(6)**	0.094***	0.041	0.079**	-0.077**	-0.095***	1			
ACSIZE	**(7)**	0.182***	0.021	0.185***	0.226***	0.174***	0.373***	1		
ACIND	**(8)**	0.230***	0.102***	0.192***	0.158***	0.149***	0.297***	0.817***	1	
LNAC_MEET	**(9)**	0.168***	0.068**	0.144***	0.133***	0.100***	0.224***	0.302***	0.306***	1
BODSIZE	**(10)**	0.166***	0.037	0.160***	0.136***	0.030	0.136***	0.430***	0.413***	0.307***
BODIND	**(11)**	0.251***	0.142***	0.193***	0.105***	0.025	0.100***	0.425***	0.678***	0.277***
LN_BODMEET	**(12)**	-0.016	0.041	-0.040	0.207***	-0.059*	0.014	0.050	0.130***	0.076**
BIG4	**(13)**	0.074**	0.105***	0.022	0.100***	0.116***	0.129***	0.279***	0.261***	0.219***
INITIAL	**(14)**	-0.016	-0.022	-0.005	-0.020	-0.044	-0.096***	-0.104***	-0.066**	0.053*
CEO_DUALITY	**(15)**	-0.082**	-0.033	-0.071**	-0.087***	-0.071**	0.013	-0.044	-0.061*	-0.058*
LOSS	**(16)**	-0.101***	-0.010	-0.104***	-0.059*	-0.063*	-0.128***	-0.272***	-0.260***	-0.177***
SALES_GROWTH	**(17)**	-0.027	0.004	-0.031	0.036	-0.036	0.007	-0.047	-0.067**	0.000
DEBTCHANGE_DUM	**(18)**	-0.011	-0.032	0.006	-0.054*	-0.012	-0.059*	-0.116***	-0.135***	-0.091***
LEV	**(19)**	-0.033	-0.015	-0.027	-0.028	0.039	0.011	-0.022	-0.023	-0.028
LN_ASSETS	**(20)**	0.230***	0.126***	0.179***	0.058	0.116***	0.171***	0.367***	0.420***	0.361***
BM_RATIO	**(21)**	-0.007	-0.003	-0.006	-0.007	-0.008	0.032	0.013	0.019	0.058*
ANNRET	**(22)**	-0.019	0.006	-0.024	-0.036	-0.009	0.046	0.007	0.021	0.097***
FOROPS	**(23)**	-0.017	0.027	-0.033	0.014	0.036	0.073**	0.044	0.098***	0.082**
EMPLAN	**(24)**	0.143***	0.113***	0.091***	-0.113***	0.053*	0.056*	0.004	0.065**	0.146***
MERGE	**(25)**	0.055*	0.022	0.047	0.037	-0.090***	0.041	-0.001	-0.032	-0.010
RESTR	**(26)**	0.115***	0.016	0.115***	0.043	-0.078**	-0.001	0.009	0.054*	0.057*

TABLE 5.3 (continued)
Pearson Correlation Coefficients

Variable		(10)	(11)	(12)	(13)	(14)	(15)	(16)	(17)	(18)
BODSIZE	**(10)**	1								
BODIND	**(11)**	0.605***	1							
LN_BODMEET	**(12)**	0.071**	0.180***	1						
BIG4	**(13)**	0.403***	0.265***	-0.119***	1					
INITIAL	**(14)**	-0.068**	-0.053*	0.018	-0.239***	1				
CEO_DUALITY	**(15)**	-0.168***	-0.122***	-0.369***	-0.011	0.027	1			
LOSS	**(16)**	-0.323***	-0.250***	0.064**	-0.249***	0.087***	-0.011	1		
SALES_GROWTH	**(17)**	0.001	-0.043	-0.024	0.005	0.018	0.004	0.013	1	
DEBTCHANGE_DUM	**(18)**	-0.144***	-0.160***	-0.006	-0.084***	0.054*	0.071**	0.126***	0.055*	1
LEV	**(19)**	-0.060*	-0.040	0.020	-0.095***	0.083***	0.049	0.089***	0.013	0.022
LN_ASSETS	**(20)**	0.581***	0.480***	0.041	0.427***	-0.068**	-0.103***	-0.455***	-0.054	-0.237***
BM_RATIO	**(21)**	0.006	-0.013	-0.004	0.030	0.072**	-0.007	0.030	-0.008	0.022
ANNRET	**(22)**	-0.002	-0.005	-0.026	-0.044	0.040	0.066**	-0.116***	0.046	0.053
FOROPS	**(23)**	0.068**	0.156***	0.304***	0.011	-0.045	-0.174***	0.033	0.009	-0.033
EMPLAN	**(24)**	0.205***	0.207***	0.065**	0.051	-0.042	-0.038	-0.071**	-0.027	-0.074**
MERGE	**(25)**	0.009	-0.032	0.056*	-0.033	0.040	0.007	-0.014	-0.003	0.039
RESTR	**(26)**	0.174***	0.152***	0.108***	0.047	0.008	-0.052	-0.010	0.052	-0.073**

TABLE 5.3 (continued)
Pearson Correlation Coefficients

Variable		(19)	(20)	(21)	(22)	(23)	(24)	(25)	(26)
LEV	**(19)**	1							
LN_ASSETS	**(20)**	-0.160***	1						
BM_RATIO	**(21)**	-0.020	0.062*	1					
ANNRET	**(22)**	-0.004	0.011	-0.006	1				
FOROPS	**(23)**	-0.059*	-0.006	-0.015	-0.018	1			
EMPLAN	**(24)**	-0.009	0.265***	0.009	-0.021	0.125***	1		
MERGE	**(25)**	-0.010	-0.001	0.078**	0.026	-0.010	-0.047	1	
RESTR	**(26)**	-0.010	0.208***	0.003	-0.033	0.124***	0.211***	0.068**	1

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

TABLE 5.4

Regression of FEERATIO on Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Expected Sign	Estimate	t-value	p-value
(Constant)		0.022	0.241	0.809
FAP_DUM	+	-0.015	-0.934	0.350
OTHER_ACCTG_DUM	-	0.001	0.094	0.925
FINANCE_DUM	-	0.031	2.076	0.038**
SUPER_DUM	-	-0.042	-2.235	0.013**
ACSIZE	?	0.015	1.447	0.148
ACIND	-	-0.038	-3.103	0.001***
LNAC_MEET	?	-0.037	-2.170	0.030**
BODSIZE	?	0.007	1.039	0.299
BODIND	-	0.000	0.016	0.987
LN_BODMEET	?	0.012	0.764	0.445
BIG4	+	0.081	3.887	<0.001***
INITIAL	-	-0.040	-2.025	0.022**
CEO_DUALITY	+	0.001	0.089	0.465
LOSS	-	-0.006	-0.336	0.369
SALES_GROWTH	+	0.000	-0.178	0.430
DEBTCHANGE_DUM	+	-0.008	-0.564	0.573
LEV	-	0.001	0.586	0.558
LN_ASSETS	+	0.014	2.981	0.002***
BM_RATIO	-	0.001	0.923	0.356
ANNRET	-	0.010	0.843	0.400
FOROPS	+	0.032	1.674	0.048**
EMPLAN	+	0.015	0.654	0.257
MERGE	+	0.015	0.834	0.203
RESTR	+	-0.016	-0.811	0.418
Industry and Year Dummies Included				
F Statistic			4.057***	
Observations			980	
Adjusted R^2			0.118***	

TABLE 5.4 (continued)

Regression of FEERATIO on Former Audit Firm Partners on Audit Committees in New Zealand

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively. The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

Dependent Variable		
FEERATIO	=	proportion of NAS fee over total fees paid to the auditor (i.e. Sum of audit fee and NAS fees)
Independent Variable		
FAP_DUM	=	1 if at least one member of the audit committee is a former audit firm partner, and otherwise 0
Control Variable		
OTHER_ACCTG_DUM	=	1 if the audit committee has a member who has experience as certified practising accountant, chief financial officer or other major accounting positions, and otherwise 0
FINANCE_DUM	=	1 if the audit committee has a member who has experience as financial analyst, venture capitalist, or other major financial management positions and otherwise 0
SUPER_DUM	=	1 if the audit committee has a member who has experience as chief executive officer and otherwise 0
ACSIZE	=	Number of members of the audit committee
ACIND	=	Number of independent members on the audit committee
LNAC_MEET	=	Natural logarithm of the number of audit committee meetings in a year
BODSIZE	=	Number of directors on the board
BODIND	=	Number of Independent board members
LNBOD_MEET	=	Natural logarithm of the number of board meetings in a year
BIG4	=	1 if the firm employs a Big 4 auditor, and otherwise 0
INITIAL	=	1 if the auditor is in the first or second year of audit engagement, else 0
CEO_DUALITY	=	1 if the Chief Executive Officer and the Board Chairman is the same person, and otherwise 0
LOSS	=	1 if the company incurred a loss, and otherwise 0
SALES_GROWTH	=	Percentage change in sales from previous year
DEBTCHANGE_DUM	=	1 if the company issued debt in a year (i.e. There is at least a 5 percent change in debt), and otherwise 0
LEV	=	Proportion of total liabilities over total assets
LN_ASSETS	=	Natural logarithm of total assets
BM_RATIO	=	book-to-market ratio
ANNRET	=	Percentage change in share price over previous period
FOROPS	=	1 if the company has foreign operations or transactions, and otherwise 0
EMPLAN	=	1 if the company has a post-retirement plan for its employees, and otherwise 0
MERGE	=	1 if the company was involved in a merger or acquisition, and otherwise 0
RESTR	=	1 if the company was involved in a restructure of operations, and otherwise 0

5.3.2 Test of H2

Another regression analysis is used to test the second hypothesis of this study. It is posited that audit committees with AFAPs will approve the purchase of more NAS from the incumbent auditor while UFAPs serving on the audit committee would approve less. This is because the AFAP shares a past employment relationship with the auditor and is likely to approve more business to the affiliated audit firm. Since UFAPs do not share a past employment relationship with the auditor, they do not have incentives to provide more business to the auditor. To test this, the main test variable (FAP_DUM) is replaced with two new test variables (AFAP_DUM and UFAP_DUM). These two variables separate FAPs based on affiliation with the auditor.

The results presented in Table 5.5 reveal that both of the new test variables are significantly associated with FEERATIO. AFAPs are positively associated with FEERATIO ($\beta = 0.104$, p-value < 0.001), which implies that the presence of an AFAP on the audit committee is associated with more NAS purchases. The reason for purchasing more NAS could lie in AFAPs sending more business to their former employer such that it could create auditor independence threats or knowledge spillover benefits for the auditor. These reasons are tested later in the Chapter.

On the other hand, the second test variable (UFAP_DUM) shows that UFAPs are negatively associated with FEERATIO ($\beta = -0.042$, p-value = 0.011). UFAPs are associated with fewer NAS purchases because they do not have incentives to send NAS business to the incumbent auditor.

It is quite evident that AFAPs approve purchase of more NAS than UFAPs on the audit committee. This finding is consistent with the second hypothesis.

The results on the expertise variables indicate that other accounting experts (OTHER_ACCTG_DUM) remains insignificant, while FINANCE_DUM ($\beta = 0.034$, p value = 0.020) and SUPER_DUM ($\beta = -0.040$, p-value = 0.016) are significant and consistent with the FAP model results. Results on most other control variables are similar to the FAP model.

TABLE 5.5

Regression of FEERATIO on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Expected Sign	Estimate	t-value	p-value
(Constant)		0.084	0.923	0.356
AFAP_DUM	+	0.104	3.467	<0.001***
UFAP_DUM	-	-0.042	-2.535	0.011**
OTHER_ACCTG_DUM	-	0.005	0.375	0.708
FINANCE_DUM	-	0.034	2.322	0.020**
SUPER_DUM	-	-0.040	-2.153	0.016**
ACSIZE	?	0.017	1.663	0.097*
ACIND	-	-0.041	-3.361	<0.001***
LNAC_MEET	?	-0.035	-2.094	0.037**
BODSIZE	?	0.010	1.447	0.148
BODIND	-	0.000	0.062	0.951
LN_BODMEET	?	0.006	0.354	0.723
BIG4	+	0.071	3.434	<0.001***
INITIAL	-	-0.042	-2.140	0.017**
CEO_DUALITY	+	-0.001	-0.036	0.971
LOSS	-	-0.006	-0.341	0.367
SALES_GROWTH	+	0.000	-0.347	0.365
DEBTCHANGE_DUM	+	-0.006	-0.457	0.647
LEV	-	0.001	0.469	0.639
LN_ASSETS	+	0.011	2.265	0.012**
BM_RATIO	-	0.001	1.005	0.315
ANNRET	-	0.009	0.789	0.431
FOROPS	+	0.038	1.980	0.024**
EMPLAN	+	0.009	0.370	0.356
MERGE	+	0.016	0.889	0.187
RESTR	+	-0.013	-0.634	0.526
Industry and Year Dummies Included				

TABLE 5.5 (continued)

Regression of FEERATIO on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

F Statistic	4.537***
Observations	980
Adjusted R^2	0.137***

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

Independent Variables

AFAP_DUM	=	1 if at least one member of the audit committee is a former audit partner and shares a past employment relationship with the current auditor, and otherwise 0
UFAP_DUM	=	1 if at least one member of the audit committee is a former audit partner and does not share a past employment relationship with the current auditor, and otherwise 0

Other variables definitions remain the same as presented in Table 5.2 and Table 4.1

The Variance Inflation Factor (VIF) is also calculated and the highest VIF is 5.9. All VIF values are below the threshold of 10 (not tabulated), which confirms that multicollinearity issues do not threaten the results (Hair et al. 2006).

Overall, the results suggest that presence of affiliated former audit firm partners on audit committees is an important determinant of NAS purchases. The results indicate that AFAPs on audit committees are positively associated with FEERATIO, while UFAPs on audit committees are negatively associated with NAS. The findings imply that the UFAPs are better monitors of potential threats to auditor independence arising from NAS.

5.4 Additional Analysis

5.4.1 Other Measures of the Dependent Variable

The study employs other measures of the dependent variable to test the sensitivity of the results. Following Naiker et al. (2013), the main dependent variable FEERATIO is replaced by LNNAF, NAS_AF and UNEXP_NAF. The regressions in Tables 5.4 and 5.5 are re-estimated for each of these three additional dependent variables.

5.4.1.1 Natural Logarithm of Non audit fees

I employ LNNAF, which is the natural logarithm of NAS fees, as a dependent variable to examine the association between FAPs and NAS. Since LNNAF is not a ratio variable, it measures the size or level of NAS purchased. I also include the natural logarithm of audit fees as a control variable since some studies argue auditors price NAS and audit services together (e.g., Ashbaugh et al. 2003; Whisenant 2003; Knechel and Sharma 2012; Naiker et al. 2013). The results are presented in Table 5.6. The test variable, FAP_DUM (β = -0.169, p-value = 0.631) remains insignificant, implying that the affiliation of the FAP could be influencing the results. In the second test, the FAP variable is replaced with its component AFAP and UFAP variables. The results show that AFAP (β = 1.483, p-value = 0.014) is significantly and positively associated with LNNAF, while UFAP is negative and significantly (β = -0.559, p-value = 0.068) associated with LNNAF. The control variables exhibit similar results. The VIFs are also calculated and all the values are well below 10 (not tabulated) (Hair et al. 2006).

5.4.1.2 Non Audit Fee to Audit Fee Ratio

After replacing the dependent variable with NAS_AF ratio and re-estimating the coefficients, the results, presented in Table 5.7, remain consistent with the main results. The FAP variable is negative and insignificantly associated with NAS_AF. The AFAP variable is significantly and positively (AFAP_DUM β = 0.288, p-value < 0.001) associated with NAS_AF, and as expected, UFAP is negatively and significantly associated (UFAP_DUM β = -0.144, p-value = 0.002) with NAS_AF. The VIFs are also calculated and all the values are well below 10 (not tabulated) (Hair et al. 2006).

TABLE 5.6

Regression of LNNAF on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Expected Sign	β	t-value	p-value	β	t-value	p-value
(Constant)		-7.331	-3.574	<0.001***	-6.556	-3.181	0.002***
FAP_DUM	+	-0.169	-0.480	0.631			
AFAP_DUM	+				1.483	2.210	0.014**
UFAP_DUM	-				-0.559	-1.490	0.068*
OTHER_ACCTG_DUM	-	-0.065	-0.202	0.420	-0.016	-0.050	0.480
FINANCE_DUM	-	-0.102	-0.309	0.379	-0.063	-0.191	0.424
SUPER_DUM	-	-1.251	-2.991	0.002***	-1.222	-2.933	0.002***
LNAF	+	0.674	5.881	<0.001***	0.696	6.084	<0.001***
ACSIZE	?	0.460	1.993	0.047**	0.488	2.122	0.034**
ACIND	-	-0.975	-3.556	<0.001***	-1.012	-3.700	<0.001***
LNAC_MEET	?	-0.165	-0.434	0.664	-0.147	-0.387	0.699
BODSIZE	?	-0.011	-0.073	0.942	0.022	0.145	0.885
BODIND	-	0.168	1.047	0.295	0.175	1.092	0.275
LN_BODMEET	?	0.221	0.610	0.542	0.126	0.347	0.729
BIG4	+	2.421	5.264	<0.001***	2.283	4.956	<0.001***
INITIAL	-	-0.716	-1.618	0.053*	-0.738	-1.673	0.048**
CEO_DUALITY	+	0.012	0.039	0.485	-0.017	-0.054	0.957
LOSS	+	-0.305	-0.779	0.436	-0.303	-0.777	0.437
SALES_GROWTH	+	-0.028	-1.264	0.207	-0.030	-1.368	0.172
DEBTCHANGE_DUM	+	0.140	0.465	0.321	0.162	0.541	0.294
LEV	-	0.028	0.786	0.432	0.025	0.713	0.476
LN_ASSETS	+	0.387	3.507	<0.001***	0.334	2.994	0.002***
BM_RATIO	-	0.015	0.459	0.646	0.016	0.502	0.616
ANNRET	-	-0.090	-0.359	0.360	-0.101	-0.402	0.344
FOROPS	+	1.681	3.909	<0.001***	1.747	4.073	<0.001***
EMPLAN	+	0.957	1.836	0.034**	0.847	1.626	0.052*
MERGE	+	0.277	0.699	0.242	0.284	0.719	0.236
RESTR	+	-0.248	-0.547	0.584	-0.212	-0.471	0.638
Industry and Year Dummies Included							
F Statistic		8.702***			8.760***		
Observations		980			980		
Adjusted R^2		0.257***			0.263***		

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

Control Variable

LNAF = natural logarithm of the audit fee paid to the auditor.

Other variables definitions remain the same as presented in Table 5.4

TABLE 5.7

Regression of NAS_AF on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Expected Sign	β	t-value	p-value	β	t-value	p-value
(Constant)		-0.045	-0.176	0.861	0.137	0.532	0.595
FAP_DUM	+	-0.063	-1.405	0.160			
AFAP_DUM	+				0.288	3.375	<0.001***
UFAP_DUM	-				-0.144	-3.045	0.002***
OTHER_ACCTG_DUM	-	-0.034	-0.826	0.205	-0.022	-0.543	0.294
FINANCE_DUM	-	0.099	2.358	0.019**	0.109	2.617	0.009***
SUPER_DUM	-	-0.147	-2.736	0.003***	-0.141	-2.657	0.004***
ACSIZE	?	0.009	0.317	0.751	0.015	0.529	0.597
ACIND	-	-0.044	-1.265	0.103	-0.053	-1.515	0.065*
LNAC_MEET	?	-0.116	-2.386	0.017**	-0.111	-2.310	0.021**
BODSIZE	?	0.031	1.628	0.104	0.039	2.057	0.040**
BODIND	-	-0.029	-1.422	0.078*	-0.028	-1.392	0.082*
LN_BODMEET	?	0.060	1.297	0.195	0.040	0.876	0.381
BIG4	+	0.184	3.119	0.001***	0.155	2.646	0.004***
INITIAL	-	-0.043	-0.750	0.227	-0.048	-0.856	0.196
CEO_DUALITY	+	0.001	0.028	0.489	-0.004	-0.103	0.918
LOSS	+	-0.003	-0.052	0.958	-0.003	-0.054	0.957
SALES_GROWTH	+	0.002	0.577	0.282	0.001	0.409	0.341
DEBTCHANGE_DUM	+	0.003	0.083	0.467	0.008	0.200	0.421
LEV	-	0.001	0.328	0.743	0.001	0.203	0.839
LN_ASSETS	+	0.030	2.190	0.015**	0.020	1.448	0.074*
BM_RATIO	-	0.002	0.557	0.578	0.003	0.639	0.523
ANNRET	-	0.024	0.733	0.464	0.022	0.676	0.499
FOROPS	+	0.030	0.551	0.291	0.046	0.860	0.195
EMPLAN	+	0.168	2.559	0.006***	0.149	2.283	0.012**
MERGE	+	0.040	0.798	0.213	0.043	0.856	0.196
RESTR	+	-0.053	-0.936	0.350	-0.043	-0.754	0.451
Industry and Year Dummies Included							
F Statistic		3.024***			3.551***		
Observations		980			980		
Adjusted R^2		0.080***			0.103***		

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

5.4.1.3 Unexpected Non audit fees

To test for unusually high NAS purchases, I follow Naiker et al. (2013) and first compute unexpected NAS fees. To compute unexpected NAS fees, I first eliminate the test variables (FAP_DUM, AFAP_DUM and UFAP_DUM) and expertise variables (OTHER_ACCTG_DUM, FINANCE_DUM and SUPER_DUM) then regress LNNAF on all other control variables. The residuals from this regression represent the new dependent variable, which is the unexpected NAS fees (UNEXP_NAF). I conduct two tests, each with and without FAP affiliation. The adjusted r-square is 0.001 and 0.004 and the F statistics are 2.993 and 1.889, respectively. The regression without FAP affiliation has an insignificant F statistic, while the regression, which examines affiliation, has a significant F statistic. Hence, the coefficients in the FAP regression cannot be interpreted (Hair et al. 2006).

TABLE 5.8
Regression of Unexpected Non audit fee on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Expected Sign	β	t-value	p value	β	t-value	p value
(Constant)		0.73	1.972	0.049**	0.698	1.888	0.059*
FAP_DUM	+	-0.038	-0.129	0.898			
AFAP_DUM	+				1.313	2.263	0.012**
UFAP_DUM	-				-0.382	-1.181	0.060*
OTHER_ACCTG_DUM	-	0.064	0.241	0.81	0.094	0.353	0.724
FINANCE_DUM	-	0.038	0.131	0.896	0.088	0.306	0.76
SUPER_DUM	-	-0.923	-2.656	0.004***	-0.919	-2.652	0.004***
F Statistic		1.889			2.993**		
Observations		980			980		
Adjusted R^2		0.004			0.001**		

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.
The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

The results presented in Table 5.8, indicate that AFAPs are positively and significantly (β = 1.313, p-value = 0.012) associated with unexpected NAS fees. On the other hand, the UFAPs is negative and significantly (β = -0.382, p-value = 0.060) associated with unexpected NAS fees.

The preceding analyses provide further support for the relationships between AFAPs, UFAPs and non audit fees. As mentioned in the previous chapter, there are two perspectives on the implications of NAS. Researchers in one paradigm argue that non audit services are associated with impaired auditor independence and higher earnings management. The other paradigm argues that the provision of NAS creates knowledge spillover benefits that assist auditors in providing a better quality financial statement audit. I test the potential explanation of why AFAPs purchase more NAS in later sections.

5.4.2 Other Measures of the Test Variable

Next, I conduct sensitivity analyses to test if the results continue to hold when variations in the measure of the test variables are used. I create a measure for each of the three test variables. FAP_PER is proportion of audit committee directors who are former audit firm partners, AFAP_PER is the proportion of audit committee directors who are affiliated former audit firm partners, and UFAP_PER is the proportion of audit committee directors who are unaffiliated former audit firm partners. Similarly, OTHER_ACCTG_DUM, FINANCE_DUM and SUPER_DUM are changed to reflect percentages, respectively.

The regression results of these alternative measures are presented in Table 5.9, which suggest that the main results continue to hold. FAPs are not significantly related to FEERATIO, AFAPs are positively associated with FEERATIO and UFAPs are negatively associated with FEERATIO.

TABLE 5.9

Regression of FEERATIO on the New Measure of Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Expected Sign	β	t-value	p-value	β	t-value	p-value
(Constant)		0.022	0.241	0.810	0.083	0.912	0.362
FAP_PER	+	-0.056	-1.120	0.263			
AFAP_PER	+				0.318	3.235	<0.001***
UFAP_PER	-				-0.124	-2.378	0.009***
OTHER_ACCTG_PER	-	0.030	0.805	0.421	0.041	1.091	0.276
FINANCE_PER	-	0.103	2.549	0.011**	0.114	2.821	0.005***
SUPER_PER	-	-0.035	-1.276	0.101	-0.028	-1.022	0.154
ACSIZE	?	0.013	1.257	0.209	0.015	1.467	0.143
ACIND	-	-0.038	-3.040	0.001***	-0.040	-3.271	<0.001***
LNAC_MEET	?	-0.043	-2.471	0.014**	-0.040	-2.323	0.020**
BODSIZE	?	0.006	0.902	0.367	0.009	1.342	0.180
BODIND	-	0.001	0.092	0.927	0.000	0.035	0.972
LN_BODMEET	?	0.008	0.516	0.606	0.002	0.132	0.895
BIG4	+	0.075	3.606	<0.001***	0.066	3.173	0.001***
INITIAL	-	-0.041	-2.038	0.021**	-0.042	-2.143	0.016**
CEO_DUALITY	+	0.003	0.241	0.405	0.001	0.089	0.465
LOSS	+	-0.004	-0.240	0.810	-0.004	-0.218	0.828
SALES_GROWTH	+	0.000	-0.250	0.401	0.000	-0.410	0.341
DEBTCHANGE_DUM	+	-0.007	-0.489	0.625	-0.006	-0.412	0.680
LEV	-	0.001	0.600	0.549	0.001	0.460	0.646
LN_ASSETS	+	0.014	2.998	0.002***	0.011	2.225	0.013**
BM_RATIO	-	0.001	0.959	0.338	0.001	1.017	0.309
ANNRET	-	0.010	0.861	0.390	0.009	0.782	0.435
FOROPS	+	0.034	1.750	0.040**	0.039	2.049	0.021**
EMPLAN	+	0.014	0.596	0.276	0.008	0.340	0.367
MERGE	+	0.017	0.975	0.165	0.019	1.049	0.148
RESTR	+	-0.012	-0.608	0.543	-0.009	-0.451	0.652
Industry and Year Dummies Included							
F Statistic		4.207***			4.634***		
Observations		980			980		
Adjusted R^2		0.123***			0.140***		

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

TABLE 5.9 (continued)

Regression of FEERATIO on the New Measure of Affiliated and Unaffiliated Former Audit Firm Partners on the Audit Committees in New Zealand

Independent Variables		
FAP_PER	=	proportion of directors who are former audit firm partners on the audit committee
AFAP_PER	=	proportion of directors who are affiliated former audit firm partners on the audit committee
UFAP_PER	=	proportion of directors who are unaffiliated former audit firm partners on the audit committee
OTHER_ACCTG_PER	=	proportion of audit committee directors who have experience as certified practising accountant, chief financial officer or other major accounting positions
FINANCE_PER	=	proportion of audit committee directors who have experience as financial analyst, venture capitalist, or other major financial management positions
SUPER_PER	=	proportion of audit committee directors who have experience as chief executive officer

Other variables definitions remain the same as presented in Table 5.4 and Table 4.1

5.4.3 Global Financial Crisis

The sample period includes company data during years of the Global Financial Crisis (GFC). I repeat the main regression by including a new dummy variable that is coded 1 if the data is from 2007 or 2008. I exclude individual year dummy variables and replace it with the new variable. The results remain consistent (not tabulated) and the GFC variable is insignificant.

I also create two subsamples, which separate data into pre-GFC period and post-GFC period. The main test is repeated using both subsamples. The results (not tabulated) continue to indicate that the GFC has had no significant impact on NAS purchase decisions made by the FAP, AFAP and UFAP decisions relating to NAS.

5.5 Audit Fees

The presence of AFAPs may undermine the independence of the audit committee. This weakens the auditors' bargaining position and implies that the auditors may not be able to successfully negotiate for adjustments to the financial statements.

The AFAP also possesses intricate knowledge about the audit tests and procedures that will be employed by the auditor. As a result, the AFAP may pressure the auditor, circumvent tests and attempt to reduce the audit fee. The current auditors may not question the AFAP because of experience and seniority. In addition, the auditor may agree to reduce the audit fee when the AFAP approves more NAS purchases from the same auditor. This may leave the auditor with a limited budget to perform a high quality audit. Essentially, the AFAP pressures the auditor to employ less extensive audit tests, which may lower the quality of the audit. Therefore, an audit fee based test may reveal these possibilities.

The audit fee model has been examined extensively by various researchers over the past three decades. I employ Beck and Mauldin (2014)'s variation of the audit fee model to examine whether the presence of AFAP is associated with lower audit fees.

Audit fee is a proxy for audit quality and it can be inferred that audit quality worsens when AFAPs are present on the audit committee to circumvent tests. Given this argument and the main results, companies which have AFAPs on audit committees are expected to have lower audit fees. This may be more pronounced if the AFAP is approving higher NAS purchases from the auditor.

The preceding analyses revealed that AFAPs purchase more NAS than UFAPs. If an AFAP is purchasing more NAS, then it may be negotiating a reduction in audit fee. To capture this effect, I first create a new dichotomous variable, HINAS, which is coded 1 if the company purchases above median amount of NAS. Following this, I create two interaction variables (HINAS_AFAP and HINAS_UFAP), which are coded 1 if a company that approves high NAS purchases has an affiliated or unaffiliated former audit partner on the audit committee, respectively, and 0 otherwise.

TABLE 5.10

Regression of Natural Logarithm of Audit Fee on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Estimate	t-value	p value
Constant	0.621	0.964	0.335
AFAP_DUM	0.468	1.398	0.162
UFAP_DUM	0.539	3.743	<0.001***
HINAS	0.625	6.227	<0.001***
HINAS_AFAP	-0.884	-2.313	0.021**
HINAS_UFAP	-0.230	-1.201	0.230
OTHER_ACCTG_DUM	0.216	2.422	0.016**
FINANCE_DUM	0.260	2.867	0.004***
SUPER_DUM	0.006	0.049	0.961
ACSIZE	-0.018	-0.274	0.784
ACIND	0.005	0.061	0.951
BODSIZE	0.159	3.808	<0.001***
BODIND	-0.075	-1.668	0.096*
LN_BODMEET	0.173	1.679	0.093*
BIG4	-0.050	-0.382	0.703
INITIAL	-0.083	-0.672	0.502
CEO_DUALITY	0.223	2.505	0.012**
LOSS	0.049	0.434	0.664
LEV	-0.107	-2.020	0.044**
LN_ASSETS	0.394	11.740	<0.001***
ANNRET	0.082	1.171	0.242
FOROPS	0.196	1.531	0.126
CA_CL	0.000	-0.078	0.938
AU_LAG	0.006	3.498	<0.001***
SEG	0.000	0.006	0.995
ROA	-0.073	-2.106	0.035**
RECINV	1.532	6.520	<0.001***

TABLE 5.10 (continued)

Regression of Natural Logarithm of Audit Fee on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Industry and Year Dummies Included	
F Statistic	20.904***
Observations	980
Adjusted R^2	0.478***

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.

The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

Variable Definitions

HINAS	=	1 if a company purchases above median amount of NAS in the year, else 0
HINAS_AFAP	=	1 if a company, which purchases above median amount of NAS has an affiliated former audit partner on the audit committee, else 0
HINAS_UFAP	=	1 if a company, which purchases above median amount of NAS has an unaffiliated former audit partner on the audit committee, else 0
CA_CL	=	current ratio (Current Assets/Current Liabilities)
RECINV	=	proportion of total assets in receivables and inventory
ROA	=	return on assets (Net Income / Total assets)
AU_LAG	=	the number of days between financial year end date and the date when auditor signs the audit report
SEG	=	number of business segments

However, the main results on UFAP_DUM show a negative association with NAS. This implies UFAPs are better monitors of the financial reporting process. Therefore, I expect UFAP to be positively associated with audit fees.

I regress the test (AFAP_DUM, HINAS_AFAP, HINAS_UFAP and UFAP_DUM) and control variables on the natural logarithm of audit fees (LNAF). The results

presented in Table 5.10 indicate that AFAPs (AFAP_DUM estimate 0.468, p-value 0.162) is not significantly associated with audit fees. However, the interaction term (HINAS_AFAP) shows that it is negative and significantly associated with audit fees (β = -0.884, p-value 0.021). This result implies that AFAPs are able to negotiate a reduction in audit fees when they purchase high amounts of NAS and are probably associated with lower audit quality.

Moreover, the UFAP variable reveals (β = 0.539, p-value < 0.001) a positive and significant relationship with audit fees. As expected, UFAPs do not purchase high amounts of NAS, and therefore the second interaction term (HINAS_UFAP) is not significantly associated with audit fees. This is consistent with the main results, which indicate that UFAPs procure fewer NAS services from the incumbent auditor and focus more on the quality of the financial statement audit.

As mentioned earlier, a positive relationship between AFAP and NAS and a negative relationship between AFAP and audit fees, could also indicate knowledge spillover benefits from the joint provision of NAS and audit services. The study examines the audit lag model in the next section to test if knowledge spillover benefits exist.

5.6 Audit Lag: A Proxy for Knowledge Spillover Benefits

Researchers in the audit lag literature argue that the joint provision of NAS and audit services create knowledge spillover benefits that assist the auditor during the financial statement audit. Knowledge spillovers improve the efficiency of the audit and subsequently create production efficiencies for the auditor (Knechel et al. 2012; Knechel and Sharma 2012).

To test whether AFAPs are associated with knowledge spillover benefits, prior literature employs audit lag as a proxy (Tanyi, Raghunandan and Barua 2010; Knechel and Sharma 2012; Knechel et al. 2012). I use an interaction term to capture the relationship between three variables (HINAS, AFAP_DUM and LNAU_LAG). The first variable, HINAS_AFAP, is coded 1 if a company, which purchases above median NAS and has an AFAP on the audit committee. Other variables are defined in Table 5.11. These variables and other control variables are then regressed on audit

lag with the results presented in Table 5.11. Knowledge spillover benefits exist if the audit lag is shorter or as interpreted through regression results when there is a negative coefficient on the variables of interest, which in this case is the interaction term AFAP*HINAS. However, the results indicate otherwise.

Results show that AFAPs who serve on audit committees that approve above median NAS purchases are positively and significantly (HINAS_AFAP $\beta = 0.169$, p-value = 0.052) associated with audit lag. This positive association implies that auditors take more time before signing the audit report of companies with AFAPs, who approve purchase of more than the median amount of NAS. UFAPs, who approve high NAS are not significantly associated with audit lag but UFAPs in general are significantly associated with shorter audit lag (UFAP_DUM $\beta = -0.064$, p-value = 0.066).

Taken together, the audit fee and audit lag results suggest that audit committees with AFAPs purchasing more NAS are associated with lower audit fees and longer audit lag, which implies there may not be knowledge spillover benefits and potential for a lower quality audit. As both knowledge spillover and lower audit fees can affect the performance of the audit, I now test the possibility that firms with AFAPs on audit committees purchasing higher NAS are also associated with earnings management.

TABLE 5.11

Regression of Natural Logarithm of Audit Lag on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	β	t-value	p value
(Constant)	4.608	36.452	<0.001***
AFAP_DUM	-0.118	-1.553	0.121
UFAP_DUM	-0.064	-1.838	0.066*
HINAS	-0.013	-0.537	0.591
HINAS_AFAP	0.169	1.943	0.052*
HINAS_UFAP	0.020	0.435	0.664
OTHER_ACCTG_DUM	-0.043	-2.113	0.035**
FINANCE_DUM	0.009	0.432	0.666
SUPER_DUM	-0.113	-4.145	<0.001***
ACSIZE	0.049	3.220	0.001***
ACIND	-0.084	-4.551	<0.001***
LN_ACMEET	-0.034	-1.387	0.166
BODSIZE	0.005	0.463	0.643
BODIND	0.003	0.306	0.760
BM_RATIO	-0.149	-4.744	<0.001***
OCF_TA	-0.008	-3.463	0.001***
LEV	0.011	0.401	0.688
ACQ	-0.030	-3.694	<0.001***
LN_ASSETS	0.001	0.400	0.690
CA_CL	-0.191	-6.486	<0.001***
BIG4	0.038	4.997	<0.001***
LNAF	-0.036	-1.326	0.185
FYE_MARCH	0.399	3.398	0.001***
ABS_DA	0.002	0.327	0.744
SEG	4.608	36.452	<0.001***

Industry and Year Dummies Included

TABLE 5.11 (continued)

Regression of Natural Logarithm of Audit Lag on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

F Statistic	9.399***
Observations	891
Adjusted R^2	0.279***

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively. The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

Variable Definitions

LNAU_LAG	=	Natural Logarithm of audit lag
ACQ	=	1 if the company engaged in a merger or acquisition or issued debt or equity, else 0
OCF_TA	=	Operating cash flow divided by total assets
FYE_MAR	=	1 if a company's financial year ends between March and September, and otherwise 0
ABS_DA	=	absolute value of the discretionary accruals derived using the Kothari et al. (2005) model.
SEG	=	number of business segments of the company.
LNAF	=	Natural logarithm of audit fees

5.7 Audit Quality and Earnings Management

By approving joint purchase of more NAS services, the AFAP may be creating independence threats. The fear of losing the client may also force the auditor to overlook irregularities in the financial statement. New Zealand has a small and competitive audit market, where auditors cannot afford to lose clients that provide lucrative fee revenues.

As a result, I further posit that the presence of an AFAP on the audit committee that purchases higher NAS is associated with earnings management. Since the UFAP is negatively associated with NAS fees and positively associated with audit fee, the UFAP does not establish conditions to exacerbate earnings management. Lower NAS fee implies that UFAP is trying to minimise the economic dependence of auditors.

The proxy to measure earnings management is aggressive earnings management, which follows Sharma and Kuang (2014) who also examine aggressive earnings management in New Zealand. Drawing on Sharma and Kuang (2014), I first estimate discretionary accruals using Kothari et al. (2005)'s discretionary accruals model. The residuals of this model are the discretionary accruals. The discretionary accruals are then used to derive aggressive earnings management.

Following Sharma and Kuang (2014), the aggressive earnings management variable is coded 1 if the residual (discretionary accruals) is in the top and bottom 20th percentiles and 0 otherwise. The aggressive earnings management measure is then regressed using logistic regression and the control variables in Sharma and Kuang (2014)'s model. I also include interaction variables to test the relationship between three variables (HINAS, AFAP, UFAP and aggressive earnings management). Table 5.12 presents the results from the logistic regression.

The results presented in Table 5.12 show that the interaction variable HINAS_AFAP ($\beta = 1.585$, p-value = 0.043) is positive and significantly associated with aggressive earnings management. This means that AFAPs who purchase above median NAS are associated with higher odds of the firm engaging in aggressive earnings management. This finding provides further support that the presence of AFAPs exacerbate auditor independence threats. Interestingly but as expected, UFAPs are negatively associated with the odds of a firm engaging in aggressive earnings management.

TABLE 5.12

Regression of Aggressive Earnings Management on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

Variable	Estimate	Wald Statistic	p value
Constant	-64.554	0.000	0.995
AFAP_DUM	-0.352	0.303	0.582
UFAP_DUM	-0.212	0.481	0.488
HINAS	0.246	1.471	0.225
HINAS_AFAP	1.585	4.100	0.043**
HINAS_UFAP	-0.392	0.938	0.333
OTHER_ACCTG_DUM	0.006	0.001	0.976
FINANCE_DUM	-0.371	3.937	0.047**
SUPER_DUM	-0.482	3.686	0.055*
ACSIZE	-0.433	9.480	0.002***
ACIND	0.564	10.797	0.001***
LNAC_MEET	-0.181	0.732	0.392
BODSIZE	-0.006	0.005	0.944
BODIND	-0.261	7.718	0.005***
ABSCFOP_TALY	-0.479	1.832	0.176
MARKETBOOK	-0.011	1.218	0.270
BIG4	-0.314	1.545	0.214
ABS_NICHNG	0.001	0.105	0.746
LEV	-0.268	1.955	0.162
LOSS	0.049	0.049	0.825
LN_BODMEET	0.453	5.870	0.015**
Industry and Year Dummies Included			
Percentage correctly predicted	73.8%		
Observations	975		
Log-likelihood Value	976.642		
χ^2	303.1666***		
Pseudo R^2	0.267***		

TABLE 5.12 (continued)
Regression of Aggressive Earnings Management on Affiliated and Unaffiliated Former Audit Firm Partners on Audit Committees in New Zealand

*, **, *** Denote significance at the 0.10, 0.05, and 0.01 levels, respectively.
The p-values are one-tailed for variables with an expected sign and two-tailed otherwise.

Variable Definitions

ABSCFOP_TALY = absolute value of the cash flow from operating activities scaled by lag total assets

ABS_NICHNG = absolute value of the change in net income over past year.

5.8 Summary and Conclusions

This chapter presented the results of the study. It shows that former audit firm partners are not associated with NAS purchases. After the former audit firm partner variable is separated based on its affiliation, the second test indicates that affiliated former audit firm partners are associated with purchases of more NAS indicating either knowledge spillover benefits or earnings management. Subsequent tests on audit lag and earnings management indicate that audit committees with affiliated former audit firm partners, who purchase high amounts of NAS are likely to not experience an efficient audit but engage in earnings management. The test on audit fees indicated that AFAPs are negatively associated with audit quality. The next chapter presents the conclusion of this thesis and a number of recommendations for regulators and practice.

CHAPTER 6: CONCLUSIONS AND POLICY RECOMMENDATIONS

6.1 Introduction

This chapter concludes this thesis following the analyses presented in the preceding chapter. The evidence presented in the preceding chapter gives evidence from a natural setting and supports the regulators in the U.S., who were correct in enacting the cooling-off rule in 2004. Although there are no regulations that restrict FAP appointments in NZ, this study calls for regulatory intervention. The results suggest that AFAPs who purchase NAS in large quantities are associated with impaired auditor independence, longer audit lags and more aggressive earnings management. These AFAPs are also associated with longer audit lags suggesting knowledge spillovers do not exist. This result is in stark contrast to the results found by Naiker and Sharma (2009) and Naiker et al. (2013). The chapter provides recommendations for regulators and practitioners. Finally, this chapter discusses the limitations of the study together with avenues for future research.

6.2 Former Audit Firm Partners and Non Audit Services

The results of this thesis indicate that affiliated former audit firm partners (AFAPs) are positively and significantly associated with NAS fees, while unaffiliated former audit firm partners (UFAPs) are negatively associated with NAS fees. The literature argues that the joint purchase of more NAS can either imply an impairment of auditor independence or create knowledge spillover benefits for the auditor to assist in financial statement audits. To ascertain whether the positive association between AFAPs and NAS fees creates independence issues, the study also presents results from audit lag and aggressive earnings management models.

The results show that the presence of AFAPs on audit committees that purchase higher than median NAS is associated with longer audit lag. This means auditors take more time to complete financial statement audits for such companies. This finding suggests that knowledge spillover benefits are not likely to exist. Moreover, the results from the aggressive earnings management tests suggest that AFAPs on audit committees purchasing higher NAS are positively associated with aggressive

earnings management. This implies that the risk of financial misstatement is higher when AFAPs are present on the audit committee and approve purchase of higher NAS from the incumbent auditor.

Therefore, the collective evidence suggests the appointment of AFAPs as directors to the audit committee is not beneficial because of the adverse effects on the performance of the external audit and financial reporting.

In all these analyses, the results on UFAPs suggest that these directors are associated with fewer NAS purchases. Moreover, UFAPs are associated with shorter audit lags and are insignificantly related to aggressive earnings management. These contrasting results for the UFAPs make them better monitors of auditor independence, and the financial reporting process. It seems that the AFAPs are more concerned with their loyalty than maintaining quality and objectivity of the financial reporting process.

The regulatory environment in New Zealand is not as strong as the United States where regulators require cooling off periods for AFAPs. The results of this thesis complement other studies on FAPs by Naiker and Sharma (2009) and Naiker et al. (2013). Their studies were based on the United States setting and regulations are in place to limit possible opportunism as exhibited in New Zealand.

There have been studies on FAPs but these have examined FAPs in senior executive positions or as directors. However, only two prior studies have examined the presence of FAPs on the audit committee and both studies have been based in the U.S. Both these studies have concluded that the cooling off rule is unwarranted. There is no other study, which examines FAPs on audit committee in another setting. This present study is the first, to consider the presence of FAPs on audit committee in a natural setting, NZ. The results of this present study are directly in contrast to the findings by Naiker and Sharma (2009) and Naiker, Sharma and Sharma (2013). The primary reason for this contrasting finding is attributed to New Zealand being a less litigious environment, and where there is no ban on non-audit services and governance “rules” are voluntary guidelines.

6.3 Recommendations and Policy Implications

A number of recommendations are presented next, based on the results of this study. These recommendations have implications on regulators and practitioners and could also help improve the financial reporting regulatory framework in New Zealand. These recommendations are:

1. The regulators in New Zealand should consider if NAS create auditor independence issues. Prior NZ studies provide evidence that the joint provision of NAS and audit services creates independence issues for the auditor and the financial reporting process (Hay, Knechel and Li 2006; Cahan et al. 2008; Wang and Hay 2013). Regulators should consider some limit or cap on the joint provision of NAS to reduce auditor independence threats.

2. Regulators should consider whether cooling-off periods should be implemented. Although it has been argued that FAPs bring in considerable financial reporting and auditing experience, the results of this study indicate that AFAPs are more loyal to their former employers (audit firm) rather than to the company shareholders. Therefore, regulators may want to consider implementing cooling-off rules like the U.S. or ban AFAPs from serving on audit committees. A cooling-off period would weaken a former partner's ties with the alma mater audit firm. However, it could reduce the currency of knowledge possessed by the former partner. Thus, regulators need to also carefully consider any unintended consequences from cooling-off periods.

3. To maintain independence over the financial reporting process, regulators can create a rule to prohibit auditors from being appointed to companies where a FAP may be present. That is, if a company has a director, who is a FAP from KPMG then KPMG cannot be appointed as the auditor of that company. This rule should apply for as long as the FAP is on the board of the company. Such a rule would place the burden on the company to determine whether the selected auditor or director is relatively more important.

4. The corporate governance code, which was implemented in 2004, needs to be revamped and made mandatory under law. At present, the implementation of this corporate governance code is voluntary and some aspects of the code are inconsistent with the NZX Listing Rules.

6.4 Limitations and Avenues for Future Research

The following are some limitations of this study and should be taken into account while interpreting the results:

1. The sample of this study consists of companies listed only on the New Zealand Stock Exchange. Hence, the results are from one setting, which is an unique regulatory setting. The results from this study should be generalized with caution to countries with similar institutional environments.

2. There are a number of dummy variables employed in this study. This may create the categorical variables problem where it is assumed that all values are equal. This may not be the case as not all AFAPs are necessarily breaching or posing threats to auditor independence.

3. This study examines only one type of affiliation, which is the employment affiliation of FAPs. There are other types of affiliations, which can affect FAP's behaviour and objectivity in the financial reporting process. FAPs can develop social ties such as being former students of the same college, or have their children enrolled in the same school. This study has not considered other forms of affiliation.

The following are some possibilities for future research for the FAP and NAS fees literature:

1. This study can be replicated in another setting such as Australia where purchase of NAS is not restricted but require only preapproval from the audit committee. This can extend the external validity of the results.

2. Other studies can also examine different kinds of affiliation of FAPs such as social ties, or ties other than employment. This would provide more information to the regulators, who can also consider how ties can influence effective governance.

6.5 Summary and Conclusions

This study provides empirical evidence that former audit firm partners (FAPs) are not significantly associated with the purchase of NAS. However, when FAPs are separated into affiliated former audit firm partners (AFAPs) and affiliated former audit firm partners (UFAPs), results show that AFAPs appear to create conditions that may exacerbate auditor independence issues, and thus, affect the quality of the financial reporting process. The AFAPs, who approve high NAS are associated with lower audit fees, longer audit lags, and higher likelihood of aggressive earnings management. The collective evidence indicates that AFAPs do not enhance the quality of the audit and the quality of financial reporting when they purchase more NAS from their alma mater. This can be problematic because continued poor quality of external independent audits and financial reporting can create management opportunism, and mask business problems. Regulators need to recognise the potential problems that can emanate from excessive non audit purchases and employment affiliations of the directors.

In contrast, UFAPs are associated with fewer NAS purchases. Subsequent tests have also indicated that UFAPs are associated with higher audit fees, shorter audit lags and are not associated with aggressive earnings management. Overall, the findings call for regulation to restrict NAS and also require a cooling-off period for AFAPs before they can be employed as directors. It is evident that AFAPs remain loyal to their previous employers and provide more business to the alma mater, which create independence threats for the auditor.

Given this problem, the study presents recommendations for a number of regulatory interventions and reforms. Regulators should consider whether NAS purchases should be banned like in U.S. or the Europe. The New Zealand legislators should

also consider implementing a cooling off rule before AFAPs are appointed to the board of directors and/or audit committee.

Furthermore, this study contributes to the existing literature with its unique findings from a natural setting. This present study is only the third study to examine the presence of FAPs on the audit committee, second study to examine it with NAS, and the first study to examine it in a setting where regulations do not ban NAS nor require a cooling off period for AFAPs. Although, this study is set in New Zealand, the results have potential implications for countries around the world with governance and institutional frameworks similar to New Zealand. The results support U.S. and EU decision to ban NAS and U.S. decision to require cooling off rule for FAPs.

Finally, future research can examine different types of affiliations that can exist between a FAP and the incumbent auditor of the company. This is vital before regulators can develop effective legislations to control and enhance the financial reporting process of companies in New Zealand. Studies such as this are important to highlight the problems relating to director appointments.

This study strongly recommends that AFAPs are not suitable candidates for independent directorships and calls for further research and possible regulatory intervention in New Zealand.

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