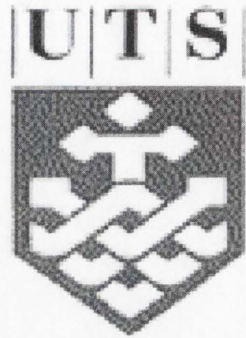


University of Technology, Sydney



**Audit Pricing – An Analysis of Spatial Oligopolistic
Competition Theory**

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for the degree of Doctor of Philosophy in Accounting*

Dec. 2006

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I certify that the work in this thesis has not previously been submitted for a degree nor has it been submitted as part of requirements for a degree except as fully acknowledged within the text.

I also certify that the thesis has been written by me. Any help that I have received in my research work and the preparation of the thesis itself has been acknowledged. In addition, I certify that all information sources and literature used are indicated in the thesis.

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ABSTRACT

This thesis applies spatial oligopolistic competition theory developed in Chan, Ferguson, Simunic and Stokes (2002) to analyse Big n audit firm pricing. The extant audit pricing studies have typically analysed audit service competition by grounding the audit pricing model in a perfect vs. monopoly competition theory which assumes that audit firms earn economic rents through product differentiation (e.g., Simunic 1980; Craswell, Francis and Taylor 1995; Ferguson, Francis and Stokes 2003). The spatial competition theory suggests that the traditional competition theory ignores the strategic interaction among closely competing audit firms. Under the spatial competition theory, audit firms are allowed to price discriminate and audit fees depend upon the specialization of the closest competitor. In equilibrium, audit firms gain market power by strategically choosing specialization sets that are different from their competitors to retain some distance from the closest competitor, and thus compete in pricing to earn “local” economic rents. This thesis extends the work of the two prior empirical studies of the spatial competition theory to examine whether Big n audit firms earn rents as “local monopolists” and investigate the impact of Arthur Andersen’s (AA) merger with Ernst & Young (EY) on Big n audit pricing in the Australian audit services market.

This thesis develops spatial audit pricing models using a spatial group indicator variable and a spatial ratio variable to capture the effects of the spatial distance between a client and its next closest competing auditor compared to the spatial distance between the client and its incumbent auditor. Using the data for clients of Big n auditors in the 5 Australian city offices (i.e., Sydney, Melbourne, Perth, Brisbane and Adelaide) across all years from 1998 to 2004, the results show that the spatially closer a client is to its incumbent Big n auditor’s specialization compared to its next closest competing Big n auditor, the higher the audit fees charged to the client. Stronger support for the hypotheses is provided after controlling for the number of the incumbent auditor’s competitors in client industries. In particular, these results are more apparent in the lower client concentrated industries where clients do not suffer from aversion to appointing specialist auditors. These results imply that client industry characteristics are important spatial attributes considered by audit firms when making strategic specialization investments to earn “local” economic rents. Additional

findings show that these results are also statistically more apparent in the small client segment of audit markets. The results of the tests of the impact of AA's merger with EY on Big n audit pricing offer limited support for the view that audit fees will increase for clients of the merged audit firm where the merger eliminates the predecessor audit firms' closest competitor for those clients. Overall, the results provide support for Chan et al.'s (2002) alternative interpretation of strategic competition among the Big n audit firms.

Key words: Spatial oligopolistic competition, auditor specialization, audit pricing, strategy, Arthur Andersen's merger with Ernst & Young

TABLE OF CONTENTS

CHAPTER 1 INTRODUCTION

| | |
|--|---|
| 1.1 Research Questions and Motivations..... | 1 |
| 1.2 Contributions..... | 6 |
| 1.3 Structure of the Thesis and Key Results..... | 8 |

CHAPTER 2 THE ECONOMIC THEORY OF DEMAND FOR AUDITING

| | |
|--|----|
| 2.1 Introduction..... | 12 |
| 2.2 The Economic Theory of the Firm | 13 |
| 2.2.1 The Contractual Nature of the Firm..... | 13 |
| 2.2.2 Principal-Agent Relationship in the Contractual Nature of the Firm | 16 |
| 2.3 Contacting Theory of the Firm and the Role of Auditing..... | 18 |
| 2.3.1 The Demand for Auditing | 19 |
| 2.3.2 Specialized Audit Technologies | 20 |
| 2.4 Audit Pricing Literature..... | 23 |
| 2.5 Summary of the Chapter | 26 |

CHAPTER 3 AUDITOR SPECIALIZATION UNDER SPATIAL OLIGOPOLISTIC COMPETITION THEORY

| | |
|--|----|
| 3.1 Introduction..... | 27 |
| 3.2 Oligopolistic Competition Theory – A Spatial Framework | 28 |
| 3.2.1 Background and Assumptions | 29 |
| 3.2.2 Spatial Oligopolistic Audit Competition Model | 30 |

| | |
|---|-----------|
| 3.3 Contracting Demand for Auditing and Strategic Auditor Specialization under Spatial Competition Theory..... | 32 |
| 3.4 Empirical Studies of Spatial Oligopolistic Competition Theory | 35 |
| 3.4.1 CFSS (2002)..... | 35 |
| 3.4.2 HSW (2003)..... | 38 |
| 3.4.3 Limitations of CFSS and HSW..... | 41 |
| 3.5 Summary of the Chapter..... | 43 |

CHAPTER 4

HYPOTHESIS DEVELOPMENT AND RESEARCH DESIGN

| | |
|---|-----------|
| 4.1 Introduction..... | 45 |
| 4.2 Hypothesis Development | 47 |
| 4.2.1 Hypotheses Addressing Research Question 1: The Impact of Spatial Distance between Auditors' Specializations and Clients' Characteristics on Big n Audit Pricing | 47 |
| 4.2.2 Hypothesis Addressing Research Question 2: The Impact of AA's Merger with EY on Big n Audit Pricing..... | 49 |
| 4.3 Sample Selection and Data Collection..... | 51 |
| 4.4 Research Design for Hypotheses 1 and 2 | 52 |
| 4.4.1 Spatial Audit Pricing Models..... | 52 |
| 4.4.2 Measurement of the Spatial Group and Spatial Ratio Variables | 55 |
| 4.4.2.1 <i>Step One: Measurement of the Spatial Distance between an Auditor's Specialization and a Client's Characteristics.....</i> | 56 |
| 4.4.2.2 <i>Step Two: Identify the Next Closest Competing Auditor for Each Client</i> | 56 |
| 4.4.2.3 <i>Step Three: Calculation of the Spatial Group and Spatial Ratio Variables</i> | 57 |
| 4.4.2.4 <i>Alternative Measurements of the Composite Score - City Client Portfolio and National Client Portfolio</i> | 57 |
| 4.4.3 Spatial Client Characteristics..... | 58 |
| 4.4.3.1 <i>The Size of a Client's Operations</i> | 58 |

| | |
|---|-----------|
| 4.4.3.2 <i>Client Diversification and Complexity: Subsidiaries and Foreign Subsidiaries</i> | 59 |
| 4.4.3.3 <i>Client Leverage</i> | 60 |
| 4.4.4 <i>The Impact of Client Industry Characteristics</i> | 61 |
| 4.4.4.1 <i>Number of Incumbent Auditor's Competitors in a Client's Industry</i> | 61 |
| 4.4.4.2 <i>Client Concentration and Auditor Specialization</i> | 62 |
| 4.5 Research Design for Hypothesis 3 | 64 |
| 4.6 Summary of the Chapter | 65 |

| |
|---|
| <p>CHAPTER 5</p> <p>EMPIRICAL RESULTS</p> |
|---|

| | |
|---|-----------|
| 5.1 Overview of the Chapter | 68 |
| 5.2 Descriptive Statistics | 69 |
| 5.3 Results of Testing Hypotheses 1 and 2: Spatial Audit Pricing Models | 71 |
| 5.3.1 Results for Hypothesis 1: Spatial Group Variable | 71 |
| 5.3.2 Results for Hypothesis 2: Spatial Ratio Variable | 72 |
| 5.3.3 Effects of Client Industry Characteristics | 73 |
| 5.3.3.1 <i>Number of Incumbent Auditor's Competitors in a Client's Industry</i> | 73 |
| 5.3.3.2 <i>Client Concentration and Auditor Specialization</i> | 76 |
| 5.3.4 Summary of Results for Hypotheses 1 and 2..... | 80 |
| 5.4 Additional Tests for Hypotheses 1 and 2 | 81 |
| 5.4.1 Effects of Client Size | 81 |
| 5.4.1.1 <i>Results for Hypothesis 1: Models (1) and (3)</i> | 81 |
| 5.4.1.2 <i>Results for Hypothesis 2: Models (2) and (4)</i> | 83 |
| 5.4.1.3 <i>Summary of Client Size Results</i> | 84 |
| 5.4.2 Model Specification Tests..... | 84 |
| 5.5 Sensitivity Tests - Choice of Spatial Client Characteristics | 85 |
| 5.6 Results for Hypothesis 3: The Impact of AA's Merger with EY on Big n Audit Pricing | 86 |
| 5.6.1 Primary Results for Hypothesis 3 | 86 |
| 5.6.2 Sensitivity Tests | 88 |

| | |
|--|-----------|
| 5.6.2.1 Choice of Spatial Client Characteristics | 88 |
| 5.6.2.2 Comparison of 2002/2001 Audit Fee Ratios..... | 89 |
| 5.6.3 Big n Audit Pricing during Pre- and Post- AA's Merger Periods..... | 90 |
| 5.7 Summary and Conclusions..... | 92 |

| |
|---|
| <p>CHAPTER 6</p> <p>CONCLUSIONS</p> |
|---|

| | |
|---|------------|
| 6.1 Introduction..... | 95 |
| 6.2 Research Question 1: The Impact of Spatial Distance between Auditors' Specializations and Clients' Characteristics on Big n Audit Pricing..... | 97 |
| 6.3 Research Question 2: The Impact of AA's Merger with EY on Big n Audit Pricing | 99 |
| 6.4 Limitations, Future Research Directions and Implications..... | 100 |

| |
|------------------------------|
| <p>LIST OF TABLES</p> |
|------------------------------|

| | |
|---------------|-----|
| Table 1..... | 112 |
| Table 2..... | 113 |
| Table 3..... | 125 |
| Table 4..... | 143 |
| Table 5..... | 160 |
| Table 6..... | 177 |
| Table 7..... | 194 |
| Table 8..... | 211 |
| Table 9..... | 226 |
| Table 10..... | 241 |
| Table 11..... | 254 |
| Table 12..... | 269 |
| Table 13..... | 284 |
| Table 14..... | 301 |
| Table 15..... | 316 |

| | |
|-----------------------|------------|
| Table 16 | 333 |
| Table 17 | 339 |
| Table 18 | 345 |
| Table 19 | 349 |
| Table 20 | 353 |
| Table 21 | 357 |