

**THE EFFECT OF NONAUDIT FEES AND FAMILY  
OWNED BUSINESSES ON EARNINGS MANAGEMENT IN  
THE INDIAN INDUSTRY**

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**Abstract**

This paper extends the findings of Frankel, Johnson, and Nelson (2002) by providing empirical evidence on the relation between nonaudit fees and earnings management for a sample of Indian firms. In addition, we investigate whether there is a greater incidence of earnings management in family owned firms versus non family owned firms. Our tests are motivated by concerns about decreasing auditor independence due to a greater economic bond between the firm and the auditor in the presence of nonaudit fees. These<sup>1</sup> concerns are reflected by the

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Securities and Exchange Commission (SEC) who issued auditor independence rules in November 2000 that required firms to file proxy statements on or after February 5, 2001 that disclose the amount of total audit fees paid along with a breakdown between audit fees and nonaudit fees. We find a positive association between nonaudit fees and the magnitude of absolute discretionary accruals. We also find a positive association between family owned firms and the magnitude of discretionary accruals.

## **INTRODUCTION**

This paper extends the findings of Frankel, Johnson, and Nelson (2002) by providing empirical evidence on the relation between nonaudit fees and earnings management for a sample of Indian firms. In addition, we investigate whether there is a greater incidence of earnings management in family owned firms versus non family owned firms. Our tests are motivated by concerns about decreasing auditor independence due to a greater economic bond between the firm and the auditor in the presence of nonaudit fees. These concerns are emphasized by the Securities and Exchange Commission (SEC) who issued auditor independence rules in November 2000 that required firms to file proxy statements on or after February 5, 2001 that disclose the amount of total audit fees paid along with a breakdown between audit fees and nonaudit fees. The Securities and Exchange Board of India (SEBI) serves a similar regulatory role in India as the SEC serves in the United States. The SEBI requires that the audit fee information be disclosed as a line item in the financial statements.

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<sup>1</sup> While the sample has been taken from the Indian Industry, the aim of the paper is to assess the results based on the U.S. audit market.

In December 2002, after the enactment of the Sarbanes-Oxley Act (2002), amendments were made to the Indian Companies Act to improve corporate governance. The concept of audit committee consisting of at least three directors has been introduced for such public companies having paid up capital of at least 50 million rupees (Indian Companies Act 1956, Section 292A). The amended Indian Companies act now restricts firms that are providing audit services to clients, from accepting certain nonattest services that may compromise the auditor's independence.

The conceptual framework for determining if a firm is independent with respect to its attest engagements has not changed much. The primary focus remains on prohibiting a member from performing management functions, or making management decisions, but there are some specific interpretations that may cause difficulty for CPA firms that provide certain IT-related services for their attest clients, and more emphasis is placed on documenting the nature of the non-attest services and relationship with the attest client

According to Section 201 of the Sarbanes-Oxley Act (2002) the following services fall outside the scope of auditors' practice -

*“(a) PROHIBITED ACTIVITIES- Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1) is amended by adding at the end the following:*

*(g) PROHIBITED ACTIVITIES- Except as provided in subsection (h), 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 required by this title or the rules of the Commission under this title or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under*

*section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the `Board'), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any nonaudit 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.*

*(h) PREAPPROVAL REQUIRED FOR NONAUDIT SERVICES- A registered public accounting firm may engage in any nonaudit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).'*

*(b) EXEMPTION AUTHORITY- The Board may, on a case by case basis, exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of services under section 10A(g) of the Securities Exchange Act of 1934 (as added by this section), to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the*

*protection of investors, and subject to review by the Commission in the same manner as for rules of the Board under section 107”.*

The key interpretation related to Information Systems service offerings relates to "designing or developing" a client's financial information systems. These services are specifically prohibited services for attest clients.

The recent challenges faced by the SEC regarding earnings manipulation have their roots in its inability to implement effective governance practices. Prior literature supports the claim that a relation exists between audit quality and earnings management. While prior research suggests that earnings overstatements are more frequent and of greater concern to auditors, high quality auditing should also, *ceteris paribus*, be a greater deterrent to earnings understatements (Frankel et al. 2002; Becker, DeFond, Jiambalvo and Subramanyam 1998).

This study will extend the relation between audit quality and earnings management by analyzing a specific factor that contributes to audit quality that is the extent of non-attest services provided by the audit firm.

The provision of nonaudit services provides the auditor increased incentive to succumb to client pressure (Simunic 1984; Beck et al. 1988). Alternatively, prior studies have found evidence that auditors have a disincentive to decreasing their independence due to a loss of their reputation (DeAngelo 1981). Frankel et al. 2002 conduct a study between audit firm fees and firms' discretionary accruals and their results exhibit that auditor independence is compromised when the ratio of nonaudit fees as compared to total fees is high. In this study, we examine the magnitude of total discretionary accruals to test the association between the provision of nonattest services and earnings management.

The second part of this study tests the pervasiveness of earnings management based on the firm's ownership structure. The

annual report format for Indian companies requires that companies disclose the distribution of shareholding into two categories: promoter's holdings and non-promoter's holdings. When a company is publicly held, there is no single majority that benefits from or can exercise control over the policies of the firm. However, in a family owned firm, the promoters hold greater than fifty-one percent of the shares of the firm. We hypothesize that due to increased influence that the promoters (owners) will be able to exert over the auditor, auditor independence, and consequently, audit quality will be reduced, which will be evidenced by the existence of earnings management.

Our analysis is based on data collected from the annual reports of 160 Indian companies filed with the SEBI for the financial year 2003. We measure the specification of nonaudit fees by calculating the ratio of nonaudit fees to total audit fees known as the FEERATIO. This specification has been suggested by the SEC and prior research. We find a significant positive association between the provision of nonaudit services, proxied by the variable FEERATIO and the magnitude of absolute total discretionary accruals, proxied by the variable DA. These results confirm the evidence provided by Frankel et al. (2002) – *firms the purchase nonaudit services manage earnings to a greater extent than other firms*.

Further, we find a significant positive association between family owned businesses and the magnitude of absolute value of total discretionary accruals. This finding is central to our study and it signifies another means of exerting pressure on the auditor through the client control of the majority of the ownership structure. In the existence of the economic bond due to high nonaudit fees and greater control in the hands of the promoters, the auditor will relinquish some of the control and management will have greater flexibility to manage earnings. Our results support this hypothesis. The remainder of the paper is organized as follows. Section II provides the basis of our hypotheses. Section III describes the research design. Section IV presents the empirical

results. Section V summarizes this study and provides concluding observations.

## **BACKGROUND AND HYPOTHESES DEVELOPMENT**

### **Rules on Auditor Independence**

In its Final Rule S7-13-00, *Revision of the Commission's Auditor Independence requirements*, the SEC states that companies must disclose information about fees billed by the auditor for the most recent year in proxy statements filed on or after February 5, 2001. These disclosures are intended to provide information that is useful to investors in arriving at a decision whether audit fees have impaired the auditor's independence.

The American Institute of Certified Public Accountants (AICPA) has also taken steps to clarify its position on auditor independence and nonattest services. The Professional Ethics Executive Committee (PEEC) released an exposure draft that proposed revisions to Rule 101 that relates to auditor independence. In September 2003, the AICPA's Code of Professional Conduct was revised to address these issues. Similar provision is followed by the Securities and Exchange Board of India (SEBI). SEBI provisions require publicly held companies to disclose audit fees and therefore, the requisite data on the various components of audit fees can be retrieved from the annual reports of these companies.

### **Hypothesis Development**

#### **Nonaudit Fees and Earnings Management**

There has been no conclusive evidence on the existence of economic bonding between the auditor and the client and the provision of nonaudit services. Different studies have found different evidence. In her research, DeAngelo (1981) finds a positive relationship between the auditor's independence and the economic bond between the auditor and the client. She argues that when consumers use the percentage of total fees dependent on one client as a quality surrogate, and this percentage is perceived to be "high" for a given auditor-client pair, the market expects auditor

independence to be reduced with respect to that client. Magee and Tseng (1990) find evidence that clients can withhold profitable nonaudit services to pressurize the auditor to grant them more discretion in reporting their financial condition and they call such nonaudit services “contingent fees”. Frankel et al. (2002) present evidence that nonaudit fees are positively associated with the magnitude of discretionary accruals. However, the findings of Ashbaugh et al. (2003) challenge the findings of Frankel et al. (2002). The results of their discretionary accruals tests differ from Frankel et al. (2002) when they adjust discretionary accruals for firm performance. Their study indicates that the results are sensitive to research design choices and they find no systematic evidence supporting the claim that auditors violate their independence as a result of clients purchasing relatively more nonaudit services.

Abdel-Khalik (1990) finds no interdependencies between audit and nonaudit fees. Simunic (1984) supports the contention that the “knowledge spillover” that arises as a result of the provision for both – audit and nonaudit services is instrumental in strengthening the economic bond between the auditor and the client.

Arrunada (1999) models a competing hypothesis that the provision of nonaudit services adds to the audit firms’ investment in their reputational capital, which in turn, is a disincentive to auditors to lower audit quality since they may lose their other clients in the event that they are found out.

As a result of the competing theoretical arguments and the mixed empirical evidence, we test the following non-directional hypothesis, stated in null form:

**H1:** The provision of nonaudit services to audit clients is not associated with earnings management.

### **Earnings management in Family Owned Enterprise**

Dechow et al. (1996) examined factors that vary across firms and that constrain or limit management's ability to manage earnings. They found that the firm's internal governance structure was one of the constraining factors. Defond and Jiambalvo (1993) studied the factors related to auditor-client disagreements over income-increasing accounting methods. Warfield et al. (1995) examined managerial ownership, accounting choices, and informativeness of earnings. Arya et al. (1998) suggest that owners can benefit from earnings management. However, the effect of ownership structure on the existence of earnings management has not been tested empirically. An ownership structure that allows the client to exert greater pressure on the auditor to further their own economic interests will demonstrate biased financial reporting in the form of the magnitude of discretionary accruals. Family owned enterprises will show a positive association with the presence of earnings management.

Thus, we test the following hypothesis:

**H2:** The provision of audit services to audit clients that are family-owned will be positively associated with earnings management.

### **Research Design**

#### **Sample Description**

Our initial sample consisted of 200 annual reports of Indian companies listed on the SEBI's Electronic Data Information Filing and Retrieval System (EDIFAR) database for the year ended 2003 that were randomly selected from the 2,545 annual reports of companies that are electronically available. From this total, we excluded four companies that were financial institutions because of the unique procedures required to estimate discretionary accruals for these firms. Of the remaining, thirty-six companies did not disclose all of the data that was required to conduct our analysis

and therefore, these companies were dropped as missing observations.

The auditor's remuneration is disclosed in the annual reports as a break-down between different categories. The main categories are audit fees, service tax, tax audit fees, reimbursement of expenses, other audit service fees. We categorize the tax audit fees and other audit service fees as nonaudit fees while the audit fees, reimbursement of expenses, and service tax are categorized as audit fees. This information can be included in the income statement as a line item or it can be disclosed separately as a part of the Notes to Accounts. The ratio of the nonaudit fees to total fees measures the extent of fees that the client is paying to the auditor for nonaudit services.

### **Shareholding pattern (Promoters holding)**

Whether a firm is family owned or not can be determined by examining the shareholding pattern of the firm. Clause 35 of the listing agreement of the SEBI requires that the distribution of shareholding be tabulated to show the different categories of shareholders such as the promoters, non-promoters, and others.

Shareholding pattern of a company is important information for the stakeholders. This information is available in the statement of shareholding pattern. The listed companies are also required to submit their shareholding pattern on a quarterly basis, within 15 days of end of that quarter in this form. The form provides information about the promoters' holding (i.e., number of shares held and the percentage of holding by the Indian promoters and the foreign promoters), the persons acting in concert and the non-promoters' holding, which includes the institutional investors, mutual funds, banks and financial institutions. The breakup of shareholding in terms of number of shares and the percentage of holding by others includes the private corporate bodies, Indian public, Non- Resident Indians (NRI) and any others available from this statement.

Table 1 reports descriptive statistics for the four major categories of shareholders for the companies in the sample. The four major categories are (1) promoters (2) non-promoters (3) Indian public (4) holding company.

### **Model Specification**

We use the ratio of nonaudit fees to total fees (FEERATIO) to specify the proportion of fees that are paid to the auditor for nonaudit services. This measure has been described by the SEC as a measure to assess auditor's independence (SEBI use similar measures used by the SEC). This measure is also consistent with prior research conducted by Glezen and Millar (1985) and Firth (1997). Positive coefficients on FEERATIO are consistent with our hypothesis that the provision of nonaudit services to audit clients creates incentives for auditors to acquiesce to client pressure to manage earnings, while negative or insignificant coefficients suggest that the provision of nonaudit services reduces earnings management or has no effect on earnings management. In order to identify earnings management, we use the model developed by DeAngelo (1986) that uses last period's total accruals (scaled by lagged total assets) as the measure of nondiscretionary accruals. The DeAngelo (1986) model can be viewed as a special case of the Healy Model, in which the estimation period for nondiscretionary accruals is restricted to prior year's observations. According to the model,

Nondiscretionary accruals can be estimated as follows:  
$$NDA_{\tau} = TA_{\tau-1} \quad (1)$$

NDA = estimated nondiscretionary accruals;  
TA = total accruals scaled by lagged total assets;  
 $\tau$  = a year subscript indicating a year in the event period.

TA is defined as net income before tax less cash from operations. The discretionary accruals are arrived at by deducting the

estimated nondiscretionary component from the total accruals of the year  $\tau$ .

$$DA = TA\tau - T\tau_{-1} \quad (2)$$

Above, DA = estimated discretionary accruals.

Using the absolute value of total discretionary accruals measures the combined effect of income-increasing and income-decreasing earnings management decisions (Warfield et al. 1995). In addition to the auditor fee measure, we include the variable (BIGFOUR) to proxy for audit quality. Prior research has shown that Big Five auditors (now known as the Big Four after the liquidation of Arthur Andersen) are less likely to allow earnings management than non-Big Five Auditors (Becker et al. 1998). FAMOWN is a dichotomous variable that is equal to 1 if the firm is family owned. We control for several factors that create incentives to manage earnings. In order to control for the effect of non-discretionary accruals that are correlated with firm performance (Dechow et al. 1995), We include two measures of firm performance, cash flow from operations scaled by lagged total assets (CFOLAG) and return on assets (ROA), defined as net income divided by average total assets. We also control for leverage (LEVERAGE), measured as the ratio of total liabilities to total assets. Prior research by Defond et al. (1994) found that leverage is associated with discretionary accruals.

AUDCHG is defined as the auditor change variable and this variable controls for the effect of existence of earnings management and the effect of a change of auditors in the financial year preceding or following the annual report period. Roberts et al. (1990) found evidence that reports by independent auditors of material weaknesses in internal accounting controls or violations of nepotism, pecuniary interest, or competitive bidding laws are related to auditor changes. DeAngelo (1981) supports the contention that in the event the auditor discovers and reports a breach, there is a high possibility of losing the client due to termination.

Chow and Rice (1982) concluded that there is a significant relation between receipt of an unfavorable audit opinion and an auditor changes. Francis (1984) found that firms that changed auditors were more likely to have reported losses or received modified audit opinions. Therefore AUDCHG is equal to 1 if a firm changes its auditor in the year preceding or following the annual report period.

Therefore, we estimate the following model:

$$DA = \alpha + \beta_1 \text{BIGFOUR} + \beta_2 \text{AUDCHG} + \beta_3 \text{FAMOWN} + \beta_4 \text{FEERATIO} + \beta_5 \text{LEVERAGE} + \beta_6 \text{CFOLAG} + \beta_7 \text{ROA} + \epsilon \quad (3)$$

The variables are defined as follows:

- DA = Discretionary Accruals;  
BIGFOUR = 1 if the firm's auditor is a Big Four firm, and 0 otherwise;  
AUDCHG = 1 if the firm changed the auditor in the year preceding or following the annual report year, 0 otherwise;  
FAMOWN = 1 if the firm is family owned, 0 otherwise;  
FEERATIO = ratio of nonaudit fees to total fees;  
LEVERAGE = ratio of total liabilities to total assets;  
CFOLAG = cash from operations, deflated by lagged total assets;  
ROA = net income divided by lagged total assets.

## RESULTS

Table 2 reports the descriptive statistics for the dependent variables. The results indicate that 28 percent of the firms with high discretionary accruals have Big Four accounting firms as their auditors (measured by BIGFOUR); eight percent of these firms switched auditor during the fiscal year (measured by AUDCHG).

The mean for FAMOWN is 0.45, which indicates that approximately forty-five percent of these firms are family owned. The results also indicate that firms on an average have negative return on assets (ROA).

The results in Table 3 for FEERATIO indicate that the purchase of nonaudit services is positively associated with the magnitude of discretionary accruals. The coefficient estimate on FEERATIO is significant (p-value = .05); thus hypothesis 1 is supported. Therefore, we conclude that the provision of nonaudit services to audit clients creates incentives for auditors to acquiesce to client pressure to manage earnings. The coefficient estimate on FAMOWN is significant (p-value = 0.00); thus hypothesis 2 is supported. The contention that ownership structure is one of the factors that create incentives for auditors to acquiesce to client pressure to manage earnings is supported.

## **SUMMARY AND CONCLUSION**

This paper provides evidence on the association between auditor fees for nonaudit services and earnings management and between ownership structure of the firm and earnings management. We find a positive association between nonaudit fees and the magnitude of absolute discretionary accruals. We also find a positive association between family owned firms and the magnitude of discretionary accruals. These results suggest a number of opportunities for further analysis.

According to Greg McCann and Michelle DeMoss (2000) of Stetson University, a family managed business can be defined in terms of control, ownership or intent. They define it as an arrangement where more than one member of a family has considerable control or influence over the operations of the business. A number of the biggest business houses around the world such as the Ford Motor Company in the USA or the Birla group in India are family owned. The family business field of study is emerging and empirical research that extends knowledge in this area would be extremely valuable.

One limitation to this study is the issue of generalization of the results; our sample size in this study comprises of only 160 observations. Other limitation is the presence of multicollinearity for our ROA variable. Future research can be performed by using recent data and by comparing the results of earnings management with firms in the United States and India, to further understand the impact of Sarbanes-Oxley Act in the Indian Market.

**TABLE 1**  
**Descriptive statistics for the four categories of the shareholding pattern (n=160)**

	<b>Mean</b>	<b>Standard Deviation</b>
<b>Public</b>	28.45525	15.85492
<b>FIIS/ Mutual Funds/NRIS/Domestic companies</b>	21.4875	17.62423585
<b>Holding Co.</b>	8.38625	20.32183913
<b>Promoters/collaborators</b>	41.5535	25.53014315

**TABLE 2**  
**Descriptive Statistics**  
**(n=160)**  
**(1 USD = 45.74 Indian Rupees)**

	Mean	Std. Deviation
<b>DA</b>	1807502314.31	9123462743.881
<b>BIGFOUR</b>	.28	.448
<b>AUDCHG</b>	.08	.264
<b>FAMOWN</b>	.45	.499
<b>FEERATIO</b>	.268	.196
<b>LEVERAGE</b>	.708	.37
<b>CFOLAG</b>	.185	.191
<b>ROA</b>	-.484	2.31

R Square = .992

Adjusted R Square = .991

F statistic = 2586.629 (p-value = 0.00)

The variables are defined as follows:

- DA = Discretionary Accruals;  
 BIGFOUR = 1 if the firm's auditor is a Big Four firm, and 0 otherwise;  
 AUDCHG = 1 if the firm changed the auditor in the year preceding or following the annual report year, 0 otherwise;  
 FAMOWN = 1 if the firm is family owned, 0 otherwise;  
 FEERATIO = ratio of nonaudit fees to total fees;  
 LEVERAGE = ratio of total liabilities to total assets  
 CFOLAG = cash from operations, deflated by lagged total assets;  
 ROA = net income divided by lagged total assets.

**TABLE 3**  
**Regression results: Dependent variable is Discretionary Accruals (DA)**  
**(1 USD = 45.74 Indian Rupees)**

$$DA = \alpha + \beta_1 \text{BIGFOUR} + \beta_2 \text{AUDCHG} + \beta_3 \text{FAMOWN} + \beta_4 \text{FEERATIO} + \beta_5 \text{LEVERAGE} + \beta_6 \text{CFOLAG} + \beta_7 \text{ROA} + \epsilon$$

Variables	Unstandardized Coefficients		Standardized Coefficients	t-value	Sig.
	B	Std. Error	Beta		
<b>(Constant)</b>	-470253115.711	211803708.361		-2.220	.028
<b>BIGFOUR</b>	190418417.493	166333030.845	.009	1.145	.254
<b>AUDCHG</b>	-505147888.935	279117359.685	-.015	-1.810	.072*
<b>FAMOWN</b>	773448416.402	154983991.063	.042	4.991	.000**
<b>FEERATIO</b>	750661540.246	387426840.014	.016	1.938	.055**
<b>LEVERAGE</b>	783445047.737	205359082.160	.032	3.815	.000**
<b>CFOLAG</b>	-4134766891.823	396558327.564	-.086	-10.427	.000**
<b>ROA</b>	-3977991788.081	30542973.448	-1.008	-130.242	.000**

\*, \*\*, \*\*\* Significant at 0.10, 0.05, and 0.01 level; Variables as defined in Table 2

**Table 4**  
**Pearson's Correlation Matrix**

	<b>DA</b>	<b>BIGFOUR</b>	<b>AUDCHG</b>	<b>FAMOWN</b>	<b>FEERATIO</b>	<b>LEVERAGE</b>	<b>CFOLAG</b>	<b>ROA</b>
<b>DA</b>	1.000	-.095	-.044	-.142	-.083	.027	.013	-.991
<b>BIGFOUR</b>	-.095	1.000	.250	-.219	.012	.162	.289	.071
<b>AUDCHG</b>	-.044	.250	1.000	-.258	.173	.260	.007	.031
<b>FAMOWN</b>	-.142	-.219	-.258	1.000	-.327	-.211	-.111	.183
<b>FEERATIO</b>	-.083	.012	.173	-.327	1.000	.233	-.113	.100
<b>LEVERAGE</b>	.027	.162	.260	-.211	.233	1.000	.298	-.029
<b>CFOLAG</b>	.013	.289	.007	-.111	-.113	.298	1.000	-.094
<b>ROA</b>	-.991	.071	.031	.183	.100	-.029	-.094	1.000

Variables as defined in Table 2

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