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PRICING INITIAL AUDIT ENGAGEMENTS: EMPIRICAL EVIDENCE FROM KUWAIT

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Key Words

Audit Fees; Audit Firms; Initial Engagements; Low-balling; Audit Independence.

Abstract

The practice of audit fee cutting for initial years (e.g., low-balling) has been an interesting research topic in audit literature for more than twenty years. Yet, empirical evidence about this important issue has typically come from English-speaking and well-developed countries, with little research, if any, examining this issue in the other parts of the world. The objective of the current study is to add to the international audit literature by providing evidence about this issue from the Kuwaiti audit market. In particular, the study aims at examining whether audit firms in Kuwait "discount" their audit fees for initial audit years. The results provide evidence of a fee "discounting" practice by audit firms during initial audit years in the Kuwaiti audit market.

Introduction

The pricing of initial audit engagements has been an appealing research topic that has attracted the attention of several audit researchers. Researchers have been generally interested in investigating whether the practice of 'low-balling' exists in certain audit markets (or segments of these markets). DeAngelo (1981) describes the practice of 'low-balling' as the setting of initial year audit fees below the sum of audit engagement start-up costs plus normal profits in hope of generating 'quasi-rents' (e.g., incumbency profits) in subsequent years. Such a practice, however, poses a threat to the independence of the auditor who will have an interest in the audit client's continued financial success, and may be at the expense of audit quality (Gregory and Collier, 1996).

Several audit studies have investigated whether external audit fees are discounted in initial audit engagements. While some of these studies

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(e.g., Ghosh and Lustgarten, 2006; Deis and Giroux, 1996; Pearson and Trompeter, 1994; Ettredge and Greenberg, 1990; Simon & Francis, 1988) offered evidence indicating that audit firms set their fees at a lower level in the initial audit year than in later years, other studies (e.g., O'Keefe *et al.,* 1994; Barefield *et al.,* 1993; Chung and Lindsay, 1988; Francis, 1984) do not report such evidence.

Prior audit research examining the discounting of initial audit engagements has been undertaken almost exclusively in the developed English-speaking countries (USA, UK, Canada, and Australia), where audit markets are quite similar, with little research, if at all, conducted in other parts of the world. The current study aims at filling this gap in the international audit literature by providing empirical evidence on this issue from the Kuwaiti audit market. Such a research endeavor seems justifiable since it is the first to examine whether the "low-balling" phenomenon exists in the Kuwaiti audit market, and in doing so it helps in deciding whether conclusions drawn from other western markets about this issue prove to be true in the Kuwaiti audit market.

While the Kuwaiti audit market may have some similarities to those of developed countries, some key differences do exist. First, the audit environment in Kuwait lacks the well-structured official guidance and control of the audit profession that are present in western developed countries. Although audit firms in Kuwait are required to perform their external audit work in accordance with the International Standards of Auditing, official observance and supervision of such adherence is quite loose. Second, unlike in western audit markets where there is an obvious competition among audit firms, competition in the Kuwaiti audit market is trivial as there is only a limited number of suppliers of external audit services in Kuwait. It is, therefore, quite appealing to see whether the lack of effective competition in the audit market has any impact on audit firms' behavior (e.g., low-balling). Third, due to the absence of an acute litigious environment similar to that in English-speaking countries, audit firms operating in developing countries, like Kuwait, do not face the same risk of incurring reputational and economic losses in the case of an audit failure (Habib and Islam, 2007). These differences distinguish the Kuwaiti audit market from other markets where prior 'low-balling' research has been undertaken, and raise the need for research to examine whether such a phenomenon exists in the Kuwaiti audit market.

Consistent with findings of prior research carried out in other coun-

tries (e.g., Craswell and Francis, 1999; Butterworth and Houghton, 1995; Turpen, 1990), the results of this study provide evidence of a 'low-balling' behavior by audit firms in the Kuwaiti audit market. In particular, after controlling for the key determinants of audit fees, the results show that external audit fee of initial audit years are significantly lower than that of later years, suggesting that audit firms in Kuwait do engage in a practice of 'fee-cutting' for new audit engagements.

The main contribution of the current study is that it offers further empirical evidence from developing countries settings complementing findings reported by prior audit research conducted in developed English-speaking countries about the existence of the practice of "low-balling" by audit firms for initial audit engagements. In particular, this study provides evidence from the Kuwaiti audit market that audit firms do "cut" their audit fees when the audit engagement is a new one. Such evidence is an important one, especially since, to the author's knowledge, there has been no prior research examining this issue in Kuwait or the surrounding Gulf Co-operation Council (GCC) countries.

The empirical evidence of fee discounting for initial audit engagements (e.g., low-balling) reported in the current study can be useful for future research investigating the economics of the audit market in Kuwait in developing audit fee models that are specific to the Kuwaiti audit market. In addition, the current study's findings provide regulators and rule-making bodies with insights about some aspects of external audit firms' behavior that can be useful in deciding about rules and regulations intended to safeguard the professional conduct of external auditors.

Background and Literature Review:

The audit literature include several studies that have investigated the possibility that audit firms price their audit services at a discount in initial years compared to subsequent years. However, results obtained about this issue have been inconclusive. While the results of some studies suggested that audit fees are, on average, lower for initial years than in later years (e.g., Ghosh and Lustgarten, 2006; Craswell and Francis, 1999; Gregory and Collier, 1996; Bong and Whittington, 1994; Simon and Francis, 1988; Baber *et al.,* 1987; Francis and Simon, 1987), results obtained by other studies did not report evidence of such a phenomenon (e.g., O'Keefe *et al.,* 1994; Barefield *et al.,* 1993;; Palmrose, 1989; Francis, 1984; Simunic, 1980).

Theory:

DeAngelo (1981) paper is among the first to provide a theoretical as well as an analytical discussion of the low-balling practice. This paper suggests that initial engagements involve start-up costs, which the incumbent audit firm would be able to avoid in subsequent years. DeAngelo argues that these start-up costs in addition to the transaction costs of hiring a new audit firms represent an advantage to the incumbent firm to set its future audit fees in a higher than market level. The low-balling phenomenon is further discussed analytically in Magee and Tseng (1990) paper. This paper extended DeAngelo's model by suggesting some conditions where the "value of incumbency" (as defined by Magee and Tseng) presents a threat to auditors' quality (e.g., independence). These conditions include disagreement among auditors in the audit market regarding the appropriateness of the reporting policy desired by the audit client, a multi-period effect of the reporting issue, and the triviality of the reporting issue to either the audit client or the auditor. Chan (1999) suggests that the practice of initial-audit fee discounting is a natural outcome of a competitive audit market, and that this price discounting occurs only when competition among external audit firms is intense.

While DeAngelo (1981) assumes that the incumbent audit firm will be able to capture the entire cost savings in subsequent years resulting from the 'incumbency knowledge' because it has more bargaining power than the audit client, Dye (1991) suggests that the audit client also has a bargaining power that it can use to keep audit fees in subsequent years at normal levels. Dye further suggests that the incumbency-related cost savings is a "pie" that can be shared by the audit firm and the audit client or exclusively captured by either one of them depending on the bargaining power of the two. According to Dye, just like the audit firm will have a bargaining power in subsequent years because it monopolizes the incumbency knowledge, the audit client will also have a bargaining power because it is the only potential buyer of this incumbency knowledge. Dye further suggests that the practice of low-balling is unlikely to exist if the quasi rents are publicly disclosed.

Empirical Studies:

Several studies in the auditing literature (e.g., Deis and Giroux, 1996; Pearson and Trompeter, 1994; Turpen, 1990; Ettredge and Greenberg, 1990; Simon and Francis, 1988; Francis and Simon, 1987) have empirically examined the low-balling hypothesis,

and found audit fees to be lower during the early audit engagement years compared to audit fees in subsequent years(1). Table 1 provides a summary of prior "low-balling" empirical studies.

Francis and Simon (1987) study is among the first to empirically investi-

Table 1
Results of Empirical Studies Investigating Pricing of Initial Audit Engagements

Study	Data Collection Method	Sample Country	Sample Period	Fee-discounting Evidence?
Private sector:				
Simunic (1980)	Survey	USA.	1976	No
Francis (1984)	Archival	Australia	1974-1978	No
Plamrose (1989)	Survey	USA	1980-1981	No
Francis and Simon (1987)	Survey	USA	1984	Yes
Simon and Francis (1988)	Survey	USA	1984	Yes
Chung and Lindsay (1988)	Survey	Canada	1979	No
Turpen (1990)	Survey	USA	1982-1984	Yes
Ettredge and Greenberg (1990)	Archival	USA	1983-1987	Yes
Barefield et al. (1993)	Survey	USA	1983	No
Pearson and Trompeter (1994)	Archival	USA	1982-1986	Mixed
Pong and Whttington (1994)	Archival	UK	1981-1988	Yes
Butterworth and Houghton (1995)	Archival	Australia	1987-1988	No
Gregory and Collier (1996)	Archival	UK	1991	Yes
Craswell and Francis (1999)	Archival	Australia	1985-1987	Mixed
DeFond et al. (2002)	Archival	USA	2000	Yes
Whisenant et al. (2003)	Archival	USA	2000	Yes
Ghosh and Lustgarten (2006)	Archival	USA	2000-2003	Yes
Public sector:				
Baber et al. (1987)	Archival	USA	1980-1984	Mixed
Roberts et al. (1990)	Survey + archival	USA	1980-1985	Yes
O'Keefe et al. (1994)	Archival	USA	1986	No
Deis and Giroux (1996)	Archival	USA	1984-1989	Yes

(1) There were some studies (e.g., O'Keefe *et al.,* 1994; Barefield *et al.,* 1993; Chung and Lindsay, 1988; Francis, 1984), however, that could not find evidence of significant fee discounts during initial audit engagements.

gate whether audit firms systematically discount their first year audit fees[2]. This studys results indicated that audit fees of initial audit engagements were significantly lower than that of continuing audit engagements. Simon & Francis (1988) further examined this issue using a cross-sectional sample of 440 public audit clients to investigate whether a price cutting systematically occurs on initial audit engagements. This studys results provided evidence of a price cutting practice at the early years' engagements that level off to normal fees levels in later years engagements. The authors concluded that discounting audit fees (low-balling) in initial audit engagements is a common practice by audit firms.

Using the percentage fee changes, Ettredge & Greenberg (1990) carried out a similar study to test whether low-balling exist for initial audit engagements. This study used data related to 389 audit engagements to investigate the existence of low-balling practice in initial audit engagements. This study found that audit clients that changed auditors have experienced audit fees cutting from their new auditors, with a mean fee discount of about 25%. Turpen (1990) used data about 57 initial audits and 89 continuing audits and found evidence that, after controlling for the influence of other audit fee determinants, audit fees were significantly lower for initial year engagements than fees for continuing engagements regardless of the audit firm's size (e.g., "Big" vs. "non-Big") or the profitability of the audit client.

Using data related to a sample 577 UK listed companies, Bong and Whittington (1994) examined among other things, whether audit firms discount their audit fees at initial year audit engagements. The study's results showed that audit fees of initial years were significantly lower than fees of other years, indicating the existence of 'low-balling' behavior. Likewise, Gregory and Collier (1996) examined this issue in the UK market, and found a significant evidence of fee cutting in the initial year of audit engagements. Butterworth and Houghton (1995) examined the presence of initial fees cutting using data related to the population of all publicly listed companies in the Western Australia region. They found that audit fees of initial audit engagements were significantly lower than those of continuing audit engagements.

Craswell and Francis (1999) used a sample of Australian companies to test whether the low-balling practice exists in the Australia. They found

(2) Earlier studies (e.g., Francis, 1984; Simunic, 1980) have examined initial-years fee discounting within their investigation of factors determining the amount of audit fees.

that the practice of initial audit fee discounting is largely not present in Australia, and that it exists only when the audit client switches from a "non-Big" to a "Big" audit firm.

Whisenant et al. (2003) examined, among other things, whether audit fees are 'discounted' during initial audit years. The results of this study showed that audit fees were significantly lower for initial audit, suggesting that audit firms do 'low-ball' their audit fees when the audit engagement is a new one. Ghosh and Lustgarten (2006) examined the fee discounting issue in relation to the audit market structure. They hypothesized and found that initial fee discounting is greater in audit engagements where the auditor is a "non-Big" firm. Their results indicated that clients who switched their auditors receive, on average, a 24 percent discount if they are switching from a "non-Big" audit firm to another "non-Big" firm, compared to only 4 percent discount if they are switching from a "Big" firm to another "Big" audit firm.

The low-balling practice has been also examined in the public sector by several studies (e.g., Deis and Giroux, 1996; O'Keefe *et al.,* 1994; Roberts *et al.,* 1990; Baber *et al.,* 1987). For example, Deis and Giroux (1996) examined the practice of initial-year fee cutting using data related to audits of independent school districts (in Texas, US). They reported evidence of a significant relation between initial audit engagements and lower audit fees[3].

Therefore, it appears that the empirical evidence on this issue is suggestive of the presence of 'low-balling' behavior by audit firms during initial audit years. What is worth noting also is that the majority of research on this issue has been carried out in developed countries' context, with very little research, if any, performed in the less developed part of the world. The lack of research about this issue in the developing countries has been a motivation of the current study, which aims at providing evidence about this important research issue using data from the Kuwaiti audit market. If this so-called "low-balling" practice exists in Kuwait, then we would expect to observe lower audit fees during the initial audit year compared to the later ones, ceteris paribus.

Research Methodology:

Sample:

The data required to test our research question was obtained using a survey sent to audit partners or man-

(3) Interestingly, Deis and Giroux (1996) also found initial audit engagements to be associated with higher amounts of audit hours.

agers of audit firms operating in Kuwait. Contact persons were asked to provide information about a stratified sample of audit engagements for which they had direct supervision. The data-gathering form was designed to collect information about several audit engagement characteristics, including those of interest in this study. In all, data about 48 audit engagements were used in the analysis of the current study.

Model:

As indicted, the main objective of this study is to examine whether the practice of audit fee cutting exists in the initial audit year in the Kuwait audit market. To examine such a research question, a cross-sectional regression model similar to those employed by prior 'low-balling' research is used. Specifically, the following regression model is used to test for the presence of audit fee cutting (i.e., low-balling) in the initial audit year:

LnAF = b0 + b1 LnSIZE + b2 LnLOCAT + b3 QUICK + b4 DE + b5 ROE + b6 NAS + b7 INITIAL

Where:

LnAF: natural log of total audit fees;

LnSIZE: natural log of the audit clients total assets;

LnLOCAT: natural log of the number of audit locations;

QUICK: ratio of the clients current assets (less inventories) to current liabilities;

ROE: ratio of the clients net income to total stockholders equity.

DE: ratio of client's total debt to stockholders' equity.

NAS: a dichotomous variable, taking the value of one if the audit firm provides non-audit services, and zero otherwise.

INITIAL: a dichotomous variable, taking the value of one if audit engagement is for the first or second year, and zero otherwise.

The dependent variable (LnAF) is the natural log of total audit fees charged by the audit firm to perform the financial statement audit. The use of such a variable is consistent with prior research (e.g., McMeeking *et al.,* 2007; Ghosh and Lustgarten 2006; Whisenant *et al.,* 2003; Craswell and Francis, 1999; Gist, 1992) suggestion of a log-liner relation between audit fees and its determinants.

Control variables:

Client Size: The set of independent variables include control variables representing factors typically believed to be significant in determining the magnitude of external audit fees. These control variables include natural log of the client's total assets

(LnSIZE), which is used here as a measure of the audit client's size. It is natural to expect that as the client size increases, the external audit team will perform more audit work, and hence, will charge higher audit fees. This hypothesized positive relation between audit fees and the audit client size is documented by most previous studies on the determinants of audit fees (e.g., Gonthier-Besacier and Schatt, 2007;; DeFond *et al.,* 2000; Craswell and Francis, 1999; Chan *et al.,* 1993; Maher *et al.,* 1992; Chung and Lindsay, 1988; Simon and Francis, 1988; Simunic, 1980). The relation between audit fees and client size is said to be a non-linear one, nonetheless, due to the economies-of-scale effect (Gerrard *et al.,* 1994). Thus, the natural log of the client's total assets is used here as a measure of audit client size.

Client complexity: The regression model includes another control variable to proxy for the complexity of the audit client. Previous audit determinants studies (e.g., Carcello *et al.,* 2002; Che Ahmad and Houghton, 1996; Chan *et al.,* 1993; Maher *et al.,* 1992; Francis and Stokes, 1986) have typically found audit fees to be influenced by the complexity of the audit client. This is true since more complex clients are expected to require more audit work. The natural log of the audit locations visited by the external audit team (LnLOCAT) is used as a measure of the client's complexity. Such a variable has repeatedly been used by previous audit research (e.g., Chan *et al.,* 1993; Davis *et al.,* 1993; Gist, 1992) as a proxy for client's complexity.

Client risk: Previous audit fee research suggests that external audit fees increase as the riskiness of the audit client increases (Seetharaman *et al.,* 2002; Chan *et al.,* 1993; Simunic, 1980;). Several measures of the riskiness of the audit client have been used in the audit literature. The current study uses two common measures of the audit client's risk; the quick ratio of the audit client (QUICK), and the debt-to-equity ratio of the audit client (DE). As suggested by previous audit research (McMeeking *et al.,* 2007; Whisenant *et al.,* 2003; Firth, 2002; Craswell and Francis, 1999), when the audit client's liquidity ratio (debt ratio) is low (high), the risk associated with the audit engagement increases, and thus audit firms tend to charge higher amounts of audit fees.

Client profitability: The return-on-equity of the audit client (ROE) is used in the current study as a measure of the client's profitability. This variable is added to the regression model to control for any potential effect of the client's profitability on the amount

of audit fees. However, such an effect is hard to predict. While a higher profitability level means a "deeper" pocket and hence a greater ability to charge more audit fees, it also means a "safe" audit client and thus a lower audit "risk premium" to charge (Karim and Moizer, 1996; Firth, 1985).

Non-audit services: Several prior audit studies have shown that the provision of non-audit services might have an effect on audit prices. These studies (e.g., Hay *et al.,* 2006; Firth, 1997; Ezzamel *et al.,* 1996; Barkess and Simnett, 1994) have typically found a positive relation between audit fees and the provision of non-audit services to the audit client. Thus, a dummy variable, taking the value of one if the audit firm provides non-audit services to the audit client, and zero otherwise, (NAS) is added to the regression model to control for its potential effect on the amount of audit fees, the dependent variable in the regression model.

Test variable:

As indicated, the research question of interest in this study is whether audit fee cutting happens in the initial audit year. To examine such a question, a dichotomous variable (INITIAL) is added to the regression model. This variable takes the value of one if the audit engagement is for the first or second year, and zero if not. Such a measurement is similar to that used in previous related research (Whisenant *et al.,* 2003). If audit firms systematically cut their audit fee in early (initial) audit years, then we would expect the regression coefficient of this variable to be both significant and negative.

Results and Analysis

Descriptive statistics:

Descriptive statistics of the study sample are shown in Table 2. The descriptive statistics indicate that the average audit fees and total assets for the sampled audit engagements is KD 3,948, and that the average total assets of the sampled audit client is KD 92,628,003. This table also shows some descriptive statistics about the explanatory variables of interest in this study.

Table 3 shows the Pearson correlation coefficients among the independent variables included in the regression model of this study. As this table shows, the correlations among the explanatory variables are fairly low (less than 0.40), with the greatest correlation coefficient value of 0.321 between the LnSIZE and the INITIAL variables. The correlation results, therefore, do not indicate a problem of multicollinearity among the independent variables included in the regres-

Table 2
Descriptive Statistics

	N	Min.	Max.	Mean	S. D.
Continuous Variables:					
Total Assets	48	140,080	772,016,000	92,628,003	176,926,110
Total Audit Fees	48	500	20,000	3,948	4,223
LnLOCAT	48	.00	1.10	0.0807	0.24480
QUICK	48	.19	437.02	12.4342	63.03425
DE	48	.00	8.85	1.2115	1.55584
ROE	48	-.14	29.26	1.3427	4.39938
Categorical variables:					
	Value	Frequency	%		
NAS	0	42	87.5		
	1	6	12.5		
INITIAL	0	31	64.6		
	1	17	35.4		

Table 3
Correlation Matrix of Independent Variables

	LnSIZE	LnLOCAT	QUICK	DE	ROE	NAS	INITIAL
LnSIZE	1.000						
LnLOCAT	.097	1.000					
QUICK	.010	-.057	1.000				
DE	.148	.024	-.130	1.000			
ROE	-.312*	-.021	-.050	.312*	1.000		
NAS	.206	.235	-.065	.198	-.030	1.000	
INITIAL	-.321*	-.122	-.114	-.298*	-.085	-.148	1.000

* Correlation is significant at the 0.05 level (2-tailed).

sion model. The Variance Inflation Factors were also computed, and the results, shown in Table 4 further indicated that a multicollinearity problem is unlikely to be present here(4).

Empirical Results:

As indicated earlier, this study's main research question is whether the practice of initial years audit fees cutting (low-balling) is present in the

(4) Since all the Variance Inflation Factor values reported were less than the critical value of 10 (the greatest was 1.353), a multicollinearity problem does not appear to be present in this case (Neter *et al.,* 1983).

Kuwait audit market. To examine such a research question, an audit fee regression model is used, including variables proxying for some audit engagement characteristics found by earlier audit research to be influential in determining the amount of audit fees, namely client size, client complexity, client riskiness, and whether the audit firm is providing non-audit services to the audit client. Table 4 shows the empirical results of this study's regression model. As this table shows, the regression model has a statistically significant F-statistic (p-value $< .000$), and that it explains about 65 percent of the variations in external audit fees.

Table 4
Regression results

LnAF = b0 + b1 LnSIZE + b2 LnLOCAT + b3 QUICK + b4 DE + b5 ROE + b6 NAS + b7 INITIAL

Variable	Predicted Sign	Estimated Coefficient	t-statistic	p-value	VIF
Intercept		3.594	4.694	.000***	
LnSIZE	+	.276	6.199	.000***	1.353
LnLOCAT	+	.064	.187	.852	1.075
QUICK	-	-.003	-2.223	.032**	1.052
DE	+	-.210	-3.515	.001***	1.315
ROE	?	.033	1.559	.127	1.316
NAS	+	.600	2.319	.026**	1.137
INITIAL	-	-.321	-1.697	.097*	1.266

Regression summary statistics:

n = 48

R-square = .65

F-statistics = 10.386

***, **, * p-value of statistical significance at the 0.01, 0.05, and 0.10 levels, respectively.

Note:

LnAF : natural log of total audit fees;
LnSIZE : natural log of the audit clients total assets;
LnLOCAT : natural log of the number of audit locations;
QUICK : ratio of the clients current assets (less inventories) to current liabilities;
ROE : ratio of the clients net income to total stockholders equity.
DE : ratio of client's total debt to stockholders' equity.
NAS : a dichotomous variable, taking the value of one if the audit firm provides non-audit services, and zero otherwise.
INITIAL : a dichotomous variable, taking the value of one if audit engagement is for the first or second year, and zero otherwise.

As the results of the regression model reported in Table 4 show, except for that of the LnLOCAT and the ROE variables, the regression coefficients of all the independent variables included in the regression model are significant at the 0.10 or better. In particular, four of the six control variables (LnASSET, QUICK, DE, and NAS) are statistically significant. Similar to findings of most previous related audit research (e.g., Ghosh and Lustgarten, 2006; Whisenant *et al.,* 2003; Craswell and Francis, 1999; Palmrose, 1986; Simunic, 1980), the LnSIZE variable, a measure of the audit client's size, is significantly and positively related to audit fees (p-value $< .000$). As anticipated, the QUICK variable is also statically significant (p-value $< .032$), and is negatively related to the amount of audit fees. This finding is consistent with prior audit fee research (e.g., Whisenant *et al.,* 2003; DeFond *et al.,* 2000; Craswell and Francis, 1999), and suggests that as the liquidity ratio of the audit clients increases, the amount of external audit fees decreases, possibly as it is viewed by audit firms as a sign of a better financial position of the audit client, and hence as an indicator of a lower audit engagement risk. Inconsistent with expectation of a positive relation between the clients debt-to-equity ratio and the amount of audit fees, the results indicate that the DE variable is negatively related to the amount of audit fees. Such a negative relation has been reported by some prior audit studies (e.g., DeFond et. al., 2000), nonetheless. A possible explanation for such a negative relation between this variable and the amount of audit fees is that audit firms might view a high Debt/Equity ratio as an indicator of a better credit rating of the audited company demonstrated by ability to have access to more debt financing relative to its equity.

The results in Table 4 also show that the NAS variable is both positive and significant (p-value $< .026$), suggesting that audit fees tend to be higher when the audit client also purchases non-audit consultancy services. This result is consistent with findings of previous audit fee research (e.g., Jeong *et al.,* 2005; Barkess and Simnett, 1994; Simunic, 1984), which suggests that the existence of a positive relationship between audit fees and the joint supply of audit and non-audit services to the audit client. The regression results also indicate that the regression coefficient of the LnLOCAT variable has the expected positive sign, but is statistically insignificant. The results also indicate that the regression coefficient of the ROE variable is insignificant.

As indicated, the main objective of this study is to examine whether the practice of 'low-balling' exists in the

Kuwaiti audit market. The INITIAL variable is included in the regression model to test such a research question. The results reported in Table 4 indicate that this variable has a negative and significant regression coefficient (p-value $< .097$). Such a result suggests that audit fees appear to be lower when the audit engagement is for initial years. Thus, consistent with findings of prior audit studies undertaken in other countries (e.g., Ghosh and Lustgarten, 2006 in U.S. audit market; Whisenant *et al.,* 2003; DeFond *et al.,* 2002; Craswell and Francis, 1999 in the Australian audit market; Gregory and Collier, 1996 in U.K. audit market; Bong and Whittington, 1994; Ettredge & Greenberg, 1990; Turpen, 1990; Simon and Francis, 1988), this study's results report evidence of discounting of initial audit engagements by audit firms in the Kuwaiti audit market.

Collectively, the results reported in this section provide evidence of a price-cutting behavior by external audit firms in Kuwait. The results of the regression model are generally consistent with predictions regarding the 'key' determinants of audit fees. In particular, the results showed that audit fees were significantly influenced by the audit client's size, liquidity ratio, and whether the audit firm is providing other non-audit services to the audit client. However, the lack of significance for the LnLOCAT variable is inconsistent with findings of prior audit research of a significant relation between audit fees and the complexity of the audit client. Lastly, the sign and significance of the regression coefficient of the test variable (INITIAL) are consistent with the notion that audit firms do provide a significant fee discount for new audit clients possibly in an effort to gain a 'footstep' in the client company.

Summary and Conclusion

This study investigated the extent to which audit firms in Kuwaiti systematically reduce their audit fees on initial audit engagements, a practice that is typically referred to as 'low-balling'. Such a research endeavor seems needed because of the lack of empirical evidence regarding this issue not only for the Kuwaiti audit market, but also for audit markets in the surrounding Middle East region. In addition, several academics (e.g., Chan, 1999; DeAngelo, 1981) have argued that the practice of 'low-balling' may lead to damaging audit independence, since audit firms would have an economic interest in the continued existence of the audited firm.

Consistent with previous audit fee research, this study's findings indicate that audit fees are significantly associated to the audit client size, client riskiness (as measured by liquidity

ratio), and the provision of other non-audit services to the audited firm. More importantly, this study's results show that the practice of 'low-balling' is present in the Kuwaiti audit market. In particular, the results indicate that audit fees are significantly lower for initial audit years engagements compared to continued engagements, suggesting that audit firms do 'discount' their audit fees when the audit client is a new one.

The results reported in this study have some research and policy implications. From a research perspective, the results documented here contribute to the audit literature in two important ways. First, the current study is the first to provide empirical evidence of the existence of the so-called 'low-balling' behavior by audit firms in Kuwait, and in doing so sets the stage for future audit examination of other elements of this important research topic in the Kuwaiti audit market. Second, this study provides evidence that the findings of "low-balling" documented in audit markets of developed countries (e.g., US, UK, and Australia) can be generalized to audit markets of other countries that are not as much developed, like the Kuwaiti market. In fact, the evidence of reported in the current study is an interesting one since it suggests that in spite of the believed minor competition in the Kuwaiti audit market, audit firms appear to engage in competitive practices like "low-balling".

From a policy perspective, audit rule-making bodies in Kuwait, knowing that audit firms do engage in the practice of 'low-balling', should take such an audit behavior into consideration when regulating the audit practice. For example, audit policy maker may impose regulations requiring the rotation of audit firms after a specific number of years to safeguard audit quality (e.g., independence) from any potential unfavorable impact of long auditor-client relation.

This study's results should be viewed in light of several limitations. First, the sample of the current study is somehow small and covers a limited time frame. Hence, an obvious extension of the current study would be to re-investigate this issue using larger samples covering longer time periods to test the robustness of inference drawn here, and to see whether the findings of this study are sample-specific or are generic to the whole Kuwaiti audit market. In addition, the high standard deviations of the data suggest that the sample used in the current study includes a diverse group of companies ranging from small to very large corporations. Future research is therefore needed to investigate whether the "low-balling" behavior is different between smaller

and larger audit clients. Second, the current study's analysis focused on examining whether price-cutting behavior for initial engagements (e.g., low-balling) is in existence in the Kuwait audit market, with no inferences made on the possible impact of such price-cutting behavior on audit quality. Hence, future research could be undertaken to examine the potential adverse effects of the practice of 'low-balling' on audit quality, especially since empirical results on the potential effects of the practice of 'low-balling' on audit quality is rare (Watkins *et al.,* 2004). Future research could also be undertaken to examine whether discounting of fees of initial audit engagements is specific to switching within same-tier audit firms, an upgrade auditor switch (i.e., from a "non-Big4" to a "Big4" auditor), or a downgrade auditor switch (i.e., from a "Big4" to a "non-Big4" auditor).

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الملخص

تسعير الارتباطات الابتدائية لتدقيق الحسابات في الكويت

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يهدف هذا البحث إلى دراسة تسعير الارتباطات الابتدائية لتدقيق الحسابات في السوق الكويتية، واختبار ما إذا كانت مكاتب التدقيق تقوم بخصم أتعاب التدقيق خلال السنوات الأولى للارتباط مع عملاء التدقيق. ولاختبار ذلك تم استخدام عينة من ارتباطات تدقيق الحسابات التي قام بها عدد من مكاتب تدقيق الحسابات في الكويت، ولقد بينت نتائج البحث أن مستوى أتعاب تدقيق الحسابات خلال السنوات الأولى من الارتباط لتدقيق الحسابات، يقل وبشكل منتظم، عنه في السنوات الأخرى، وهو ما يشير إلى وجود ظاهرة خصم أتعاب تدقيق الحسابات للارتباطات الأولية من قبل مكاتب تدقيق الحسابات في الكويت.

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