

EVALUATION OF AUDIT FEES AND FREE CASH FLOW

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ABSTRACT

Audit fees companies with free cash flows can be changed according to agency problems. This study shows how the hypothesis of free cash flow of a company increases the audit fees. The point of this research is to determine whether there is a meaningful connection between free cash flow and audit fees. Therefore in order to determine the connection, the data's have been collected from fifty companies who are members of the Tehran Stock Exchange during the years 2008 – 2013 together from the Tehran Stock Exchange site. The statistics techniques are used for hypothesis test, regression of different kinds. The present research shows three hypothesis with respect to high free cash flow, debt and dividend, out of which the audit fees have been paid. The result shows that the companies with high free cash flows pay higher audit fees. Alternatively the result shows the companies with debt and small dividends pay less audit fees.

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KEY WORDS

Audit, debt, cash flow

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INTRODUCTION

One of the factors affecting changes in audit fees to compensate for the additional risk and audit efforts based on free cash flow agency problems. There are complex documents on the relationship between audit fees and free cash flow are agency problems. The purpose of this research is to better understand the factors. Are agency problems free cash flow audit risk and trying to show the different audit fees? Companies with high free cash flow and high growth outlook can show this growth potential in the domestic investment. This will allow capital market to show less research and review with these companies. Alternatively it is required companies with high free cash flow and high growth outlook to have very active auditors [16]. Managers in high free cash flow companies prefer to show negative investment in net present value (NPV) rather than to pay dividends [13]. Gul and Tusi point out a positive factor in connection between free cash flow agency problem and audit fees for companies with low income. They also have shown that the higher debt will weaken the positive relationship. Companies often use debt to mitigate the problems of free cash flows agency, thereby reducing the funds available to managers.

Capital reduction or dividends has increased, the mechanism are well equipped to manage cash surplus, however dividends paid may be less efficient than debt [18]. Jensen monitoring hypothesis debt understands that the higher cost of debt assumption of free cash flow agency reflected in audit fees is adjusted. In companies with high growth and low debt levels to avoid the problems of lack of investments and shortages of some debt related to monitoring the activities of auditors lead. Where the dealers are usually larger companies that are clearly beyond the duties of auditors and debt surveillance audit of financial statements is more important not to expand.

Companies with high free cash flow and low growth have high audit fees. Free cash flow supports and represents the idea that the auditors recognize as the agencies problems. For example the possibility of manipulating the accounts and financial statements of companies with free cash flow rising and higher growth has higher audit fees [7], while this relationship may be due to manipulation of financial statements, it is also estimated that this reflects the lack of transparency of investment managers on projects with positive net present value with an increasing complexity in the size of some projects with positive growth.

This study examines the variability of audit fees in excess of free cash flow deals with companies. The aim is to better understand the mix evidence that has existed in various researches. Increase in audit fees to compensate for the extra risk free cash flow is due to agency problems. For example, the audit fees for companies with high free cash flow and poor growth outlook must be higher, because the assumption is that high free cash flow and low

growth prospects encourage management till the free cash flow is an unwise investment and covering such behavior by manipulating financial statements [10].

In order to analyze the creation of value for shareholders, companies free cash flow is specially very important because managers can identify opportunities for growth through appropriate, these funds can therefore be invested in positive projects so the shareholders will highly benefit from this but it should be noted with regard to the conflict of interest between managers and owners, specially managers of net flows in projects with positive business units will not invest.

It is possible that some of the managers will want to invest in projects with positive net present value, in order to satisfy their personal investments in short periods. Jensen in 1986 was the first person to implement this idea. Jensen forecasted the free flow cash costs are in the projects related to negative net present value investments. According to him the unit managers with high free cash flows and low growth, will manage earnings to meet their personal interests. Therefore it is expected that free cash flow can be regarded as an incentive to manage earnings. Increase in audit fees to compensate for the additional risk that free cash flow is due to agency problems.

For example, audit fees for companies with high free cash flow and low growth prospects should be higher, because it is assumed that management encourages high free cash flow and low growth prospects till free cash flow as unwise investment and to cover such behavior by manipulating financial statements [15]. Regular cash effects should be free flow cash for firms with high and low growth is outstanding, also companies with high free cash flow and high debt imposes a lower risks because some contractors are debt free cash flow less continuity [2].

Companies often use debt as a key for controlling the problems and to represent the free cash flow and thereby also reduce the funds available to managers. However, a decrease in capital or dividend increased also good mechanisms for managing extra cash; however, dividends paid may be less efficient debt [12]. It shows the debt ratio represents the relationship and complexity of the entity's operations through the financing of outside ownership. The increase in debt due to the emphasis between management and creditors representing, the audit services and fees may apply for these services increases [21].

In this study we used the model proposed audit fees and the dummy variable free cash flow in two states such as higher or lower to assess whether companies with high free cash flow have higher audit fees, in this model the other factors are controlled on audit fees.

The main hypothesis of this study includes the following:

First hypothesis – There is a significant relationship between free cash flow and audit fees.

Second hypothesis – There is a significant relationship between debt / free cash flow and audit fees.

Third hypothesis – There is a significant relationship between dividend / free cash flow and audit fees.

MATERIALS AND METHODS

Since this study sought to examine the relationship between the independent variable free cash flow, debts, dividends and the dependent variable is the audit fee. This research is to study the correlation and regression analysis was used to examine the relationship between these variables. In the study, companies based on free cash flows are divided in to two parts and based on the audit fee model and variable dummy free cash flow and the theory of growth opportunities, dividends and debt are used.

The model used to test the first hypothesis is as follows:

On the first hypothesis, the test T is used to compare the two groups at a time to determine which group has the most audit fee logarithm and the model regression below is used:

$$\text{Audit fee} = \alpha + \beta X + e$$

Review of Literature

Jaggi (2005) said free cash flow due to increased risk creates damages to the value of investments. He also suggested that the conflict between the interests of shareholders and managers in firms with high free cash flow and low growth prospects may be more severe. Many of the results of the use of free cash flow for investment and financing activities were investigated. Zaree (2005) examined the impact properties of audit fees for audit firm and employer. The study of factors affecting audit fees from the perspective of the audit firm's partners has been investigated. The results showed the affects it has on industrial expertise of audit firm to audit fees because the qualified auditors do their audit procedure in less time and with more confidence, so therefore the quality of these auditing institutions are higher than other audit institutions. One reason is that managers with free

cash flow of the companies' resources may be wasted on extravagant projects and relegated to the adjusted value of the companies' financial statements to manipulate [2]. Effort and increased audit risk as a result of the manipulation that led to higher audit fees. The nature of the commitments may force the auditors and audit risks to increase the audit fees [6]. It also raises questions about the credibility of the management [2]. Similarly the auditors may identify the audit as a potential for management earnings as a risk factor [4]. When companies with high free cash flow and low costs reflect the high representative, companies with high free cash flow and high growth may also prefer high agency costs and therefore justify additional audit. For example, companies with high free cash flow and high growth can fund internal growth opportunities and may be subject to less careful consideration of capital market [10]. Companies with high growth can also be more difficult to audit. They have a higher ratio of market value to intangible assets at their disposal and thus have a higher value, the recognition, measurement and auditing are more difficult as [21]. Suggested, it may be difficult to notice in companies with high growth that the behavior of the management can be opportunistic, in particular it can increase audit fees. The companies with high free cash flow and high growth tend to have lower levels of debt [9], the lack of care and control of debt, potentially creating additional audit work. Simunic (2008) examined the effects of several variables on fees. Initial investigations on audit fees in developed countries such as USA, Australia, UK were carried out and it was followed by other countries with respect to measures affecting audit fees. Audit fees are higher for audit firms with financial problems in the field of advanced technology [12]. Gaver (2009) believe the quality of the auditing standards generally accepted audit work carried out investigation to accept the audit report, and empirically demonstrate the fraud audit reporting standards by increasing audit fees reduced. Stulz (2006) research result obtained from twenty different countries study compare the result was that increased losses resulting from increased quality of service and the auditors addressed. The auditors also for the development of audit, remuneration more requests. Great audit institutions are different ways to increase your reputation. This provides them with higher audit fees [14]. Audit of the expected quality of service may mean quality of service is less well-known audit company, but due to the early harvest buyer, price increases famous institutional audit services [4]. Research in the field of market power, a wide range of relative exclusivity and distinction to describe the service providers and the fee is higher [15]. A study on the causes of litigation against auditors concluded that increased audit fees, legal claims arising from loss decreases [22]. Auditors in a more competitive market fee to cover expected future losses our customers demand [20].

Theoretical framework

FCF: free cash flow is a measure to measure the performance of companies' shows that the company's cash expenditures required to maintain or expand after performing assets at its disposal. Free cash flow is important in the sense that it allows companies to seek opportunities to increase shareholder value will. Without having cash, develop new product, conduct business education, cash benefits paid to shareholders and debt relief is not possible. Information about the cash flows of business unit to provide a basis for users of financial statement to evaluate its ability to generate cash in the unit and the unit needs to apply these funds is useful. The economic decisions taken by users require the ability to create business unit cash, timing and ensure that it is [21].

Debt: The relationship of agency debt and complexity of the entity's operations outside of property financing through the shows. The increase in debt due to the emphasis on the relationship between management representatives and creditors may demand for audit services and the right of these services requires increased [11].

Dividend: Dividend policy The Company can indicate whether or not the actual reported earning and operating performance of the business unit is a fair offer. In fact, the directors took the decision to increase dividend payments or they feel they significantly affect the accounting method is not working and is unlikely to reduce the dividend in the future. In this context, profit sharing not only a sign for future profitability is also a good indicator of the quality of earnings. The dividend is expected to be an effective way of monitoring the executive management for their help, the earnings less tempted.

Audit fees: Auditor economic benefits funded through fee from the contract signed with the employee income. Auditors for audit services pricing various factors, and much research has been done in relation to the identification and assessment of these factors. The basis for determining the remuneration of the auditors, audit officer working life that is commensurate with the progress billing. Hourly rate of remuneration of the auditors on the basis of experience and skills and thus bear the responsibility that is different. According to the survey done by auditing fees included fees and other direct costs and overhead allocation of direct labor hours in total is estimated to amount Rial [3]. In less developed countries, audit fees based on level of activity and audit features auditors determined of audit fees in most of these countries complexity and volume of operations and the size of the company that audits the financial statements of the company have been investigated [8]. The independent auditors to monitor and reduce the increasing pressure faced by audit fees. This has caused the auditor and the work to facilitate this work investigates the relationship between accounts to pay fees, factor effecting audit fees will be divided in two groups. CPA firm is the first group and the second group features, Characteristics of the employer or the company that gives the CPA firm invited [5].

In this study we have chosen the following companies who are eligible and amongst members of Tehran Stock Exchange.

- 1) The companies who were accepted before year 2008
- 2) The company during the financial year to be examined
- 3) Data about the company is available
- 4) The company is a corporate member of the Tehran stock exchange. Since the variable remuneration of the research is

to audit the company in the sample, this variable in the general and administrative expenses has been disclosed according to this study 300 company has been chosen between years 2008 to 2013.

Data	Variable
Free Cash Flows	Free Cash Flows: Former benefit before tax gain *(1-tax rate) +current years amortization payments-fund expenditure-funds increase or decrease/ book value of shares owners rights.
Dividends Benefit	Each share s Division benefit: Profit dividing / spread shares amount
Debt ratio	Whole property = whole due
Investing Growth Opportunity	Growth opportunity ; book values of shares owners rights – shares owners market value

Research data are classified as follows:

In this research the relation between Dependent Variables (Audio fees) and independent variables (Free Cash flows, Dept ratio and dividend benefit) would be analysis. In this paper we use Pearson correlation coefficient factor & single variable regression for Data analysis. Former data in former of files in expanded Excel software designed & done & then SPSS used for data analysis. Kolmogroph-Esmirenoph (Normalizing Data test):

HO= Data are Normal
H1= Data are abnormal

Table: 1. Normalizing Data test

Observed amount	Meaningful level	HO
300	333.0	Confirmed

RESULTS

First hypothesis testing Conclusion:

HO: Between Free Cash flows (FCF) & Audit fees there is no meaningful relation.

H1: Between Free Cash flows (FCF) & Audit fees there is a meaningful relation.

For testing this analysis we used Non parametric Eta correlation coefficient.

Table: 2.: Correlation taste between Cash flows (FCF) and Audit fees

Scale	Variable	Value	Meaningful level	HO
Ranking	FCF	839.0	0090.0	Rejected

When an element has level or nominal scale & the other element has distance or comparative scales, the Non parametric Eta correlation coefficient.

This index expresses that with knowing a certain variable, how the predicted errors for the other variables would be decreased. With attention to gained conclusion from table 2, for the sake of meaningful level that is less than 0.50, SO HO rejected & H1 confirmed. According to level of (Sig = 0.009), There is meaningful correlation between Audit fees & FCF in accepted Companies in Tehran stock Market. FCF value is equal to 839.0, it means FCF can describe 839.0 of changes in dependent variable (Audio fees).

Second hypothesis test:

HO: between dept / FCF & Audit fees there is no meaningful relation.

H1: between Dept / FCF & Audit fees there is a Meaningful relation.

For testing this hypothesis we estimate this regression model:

$$1) \text{ audit fees} = a + \text{BDA} + e$$

DA= Dept ratio

Regarding to those Companies divided to up & down levels as to FCF, table 3 is related to down level Companies FCF, table 3 is related to down level Companies FCF.

Table: 3. Correlation between Audit fee and debt ratio in down class of free cash flow

HO	Dorbin Watson	Sig	Determine coefficient	Correlated coefficient	dependent Variable	Independent Variable	Regression Equation
Reject	012.0	0	120	346.0	Audit fees	Dept ratio	1

Regarding to **Table -3** results, with having a meaningful level is less than 05.0 so H1 confirmed & HO rejected. According to correlation coefficient about 346.0 in significant level 95%, there is a positive & meaningful relation between audit fee and debt ratio in accepted companies in Tehran stock market. Determination factor(R) is 120.0, means that dept ratio variable can express up to 120.0 of Changes in dependant variable (Audit fees) singly.

Now in up level of FCF the relation between Audit fees &dept ratio will be express. **Table- 4** is related to up level free Cash flow of Companies.

Table: 4. Correlation between Audit fees &dept ratio in up level of free Cash flow

HO	Dorbin Watson	Sig	Determine coefficient	Correlated coefficient	dependent Variable	Independent Variable	Regression Equation
rejected	971.0	000.0	314.0	560.0	Audit fees	Dept ratio	2

Regarding to **Table- 4**, with having a meaningful level less than 05.0 , so HO reject and H1 would be Confirmed. According to correlation coefficient 560.0, in significant level 95% between about fees &dept ratio there is a positive & Meaningful relation in Tehran stock markets accepted Companies. Determination factor is 314.0, means that dept ratio variable can express up to 314.0 changes of dependant (Audit fees) variable. Regarding to upside table, correlation coefficient in up FCF levels is more than down level; this element shows a higher correlation between Audit fees &dept ratio in upper level of FCF.

Third hypothesis test:

H0: there isn't any meaningful relation between dividend benefit / FCF & audit fees

H1: there is a Meaningful relation between dividend benefit / FCF & audit fees

For testing this hypothesis we estimate this Regression model:

2) $Audit\ fees = \alpha + B\ Div + e$

Reference to companie s division two levels (up & down) about FCF, this table is related with down leved of FCF in companies .

Table: 5. Correlation between Audit fees & dividend in down level of free Cash flow

H0	Dorbin Watson	sig	Determine coefficient	Correlated coefficient	dependent Variable	Independent Variable	Regression Equation
Rejected	862.0	000.0	111.0	333.0	Audit Fees	Division Benefit	3

Regarding to table 5 results, with having a meaningful level less than 05.0 so H0 reject and H1 would be confirmed. Reference to correlation coefficient 333.0 in significant level 95%, there is a Meaningful & positive relation between division benefit & Audit fees, in Tehran Stock market accepted Companies. Determination Factor is 111.0, means that Division benefit can express 111.0 changes of dependant variable (Audit fees) singly.

Now in upper level of FCF, the relation between Audit fees and division benefits would be expressed. **Table- 6** is related with upper level of FCF in Companies.

Regarding to **table- 6** result, with having a meaningful level less than 05.0, so Ho reject and H1 is confirmed. According to correlation coefficient equal to 471.0, in significant Level 95%, there is a Positive relation between division benefit and Audit fees, in Tehran stock market accepted Companies. Determination factor is 222.0 means that Division benefit can express 222.0 units of changes of dependant variable (Audit fees).

Table: 6. Correlation between Audit fees & dividend in up level of free Cash flow

H0	Dorbin Watson	sig	Determine coefficient	Correlated coefficient	dependent Variable	Independent Variable	Regression Equation
Rejected	146.2	000.0	222.0	471.0	Audit Fees	Division Benefit	3

Regarding to up side table result, correlation coefficient in upper level of FCF in Companies, is more than down levels. This shows that, there is a higher correlation between Audit fees & division benefit in upper levels of FCF.

Meaning fullness of Regression Equations test (F test)

In this sector, the regression equations meaning fullness would be tested by variance analysis in this way.

Table : 7. ANOVA table

significant level	F Statistic	Squares Average	DF	Total Squares	Regression Equation	
(a)000.0	145.18	719.1	1	719.1	Regression	1
		095.0	133	598.12	Residual	
		-----	134	317.14	Total	
(b)000.0	512.74	249.6	1	249.6	Regression	2
		084.0	163	671.13	Residual	
		-----	164	920.19	Total	
(c)000.0	557.16	585.1	1	585.1	Regression	3
		096.0	133	732.12	Residual	
		-----	134	317.14	Total	
(d)000.0	581.46	4279.4	1	427.4	Regression	4
		095.0	163	493.15	Residual	
		-----	164	920.19	Total	

Dependant Variable: Audit fees.

- (a) Predictors: (fix Variable): Dept ratio in down level FCF.
- (b) Predictors : (fix Variable): Dept ratio in upper level FCF.
- (c) Predictors : (fix Variable): Division benefit in down level FCF.
- (d) Predictors: (fix Variable): Division benefit in upper level FCF.
- (e) Independent variable: Audit fees.
- (f) As you see in table 7, meaningful level in all equations is less than 05.0, so all the Regression equation are meaningful.

Fee predictive model offer by each variable (Test T)

After we understand that all of the regression equation is meaningful by test F, Now we want to check which variables factor is against 0 and what its amount. For doing this test, the coefficients tables was used, regarding to each independent variable, dividend predictive bi variable model offered that you see in fallow.

significant level	T statistics	Standard factors		Non standardized factor		Regression Equation	
		Beta	Standard deviation	Variable coefficient			
000.0	409.54		38.0	082.0	Fix variable (a)	1	
000.0	260.4	346.0	033.0	142.0	Dept ratio		
000.0	783.44		046.0	058.0	Fix variable	2	
000.0	632.8	560.0	053.0	455.0	Dept ratio(c)		
000.0	556.70		030.0	141.2	Fix variable	3	
000.0	069.4	333.0	001.0	000133.0	dividend(d)		
000.0	919.67		033.0	248.2	Fix variable	4	
000.0	825.6	471.0	001.0	000183.0	dividend(e)		

Dependant variable: Audit fee

- (g) Previsions (fix variable): Dept ration in down FCF
- (h) Previsions (fix variable): Dept ration in upper FCF
- (i) Previsions (fix variable): Division benefit in down FCF
- (j) Previsions (fix variable): Division benefit in upper FCF
- (k) Independent V: Audit fees

As we see in table 8, all variables factors are against 0. Regarding to Alfa and B result, we can reference to any changeable variables, a bi variable prediction model in Audit fees like following:

- 1) Audit fees $i = 2.082 + 0.142 DA + e_i$
- 2) Audit fees $i = 2.058 + 0.455 DA + e_i$
- 3) Audit fees $i = 2.141 + 0.000 DIV + e_i$
- 4) Audit fees $i = 2.248 + 0.000 DIV + e_i$

CONCLUSION

As is clear from the above hypothesis and result between free cash flow and audit fees and there is a significant positive relationship. Companies with high free cash flow and free cash flow high risk than companies with low risk and high risk of a more rational use of free cash flow do not have to use more cash and assets [5]. On behalf of the companies, which are usually larger and duties of auditors and supervision are clear debt extends beyond the audited financial statement, is more important. Audit fees for companies with free cash flow, free cash flow if investment managers are unreasonable and cover up some of the financial statement to manipulate behavior, they will be high [10].

As the above hypothesis, and the result have been determined. A significant positive correlation between debt and audit fees, and this is on the top floor more free cash flow and also according to the results of the variable debt is adjusted free cash flow that will reduce audit fees, firms with high free cash flow growth opportunities tend to have less debt. Companies often use debt to adjusted free cash flow difficulties and Agencies, and thereby also reduce the funds available to administrators [19]. Debt reduction in audit fees in companies with high free cash flow and low growth has direct relationship [21]. Debt reduction in the amount of excess cash in the hands of managers is, due to poor management of free cash flow to additional audit resources audit additional resources need to be increased audit fees and additional costs due to reduced profits for the benefit of shareholders is, due to the high free cash flow and reduce costs, agency costs create free cash flow is represented by a decrease in audit fees.

As the above assumptions and result specified between free cash flow and dividend and audit fees and positive relationship exists; also according to the result of the variable dividend free cash flow adjuster that audit fees will increase. The result show that dividend has the role of regulators is to free cash flow. Cash dividends is a factor authentication, in that case, funds under management and reduced investment unusual increase agency costs do not prevent, after the results, with an increase in free cash flow and reduced dividends representing costs, audit fees will decrease.

As you can see the debt ratio and dividend and positive relationship with the audit fee and according to the result obtained to reduce audit fees are. Dividend similar debt on which the interest as soon as a commitment is, with the exception that the dividends of debt more flexibility. Also, the pyramid finance the debt and interest free cash flow after dividends paid, with respect to these points may give better control mechanisms in force managers to pay cash is coming [8].

According to the result of the research, the following suggestions can be provided:

- 1 - According to the result of research that companies with high free cash flow and financial risk, the assets of other companies may hold more cash, and it is suggested that managers in their investment decisions are carefully otherwise it should increase audit fees.
- 2 - Since debt and dividends and dividend cash out methods are like debts, on which interest is mentioned as a commitment is announced, the difference is that dividends of debt have more flexibility, also in the pyramid financing, first the debt and the interest on free cash flow dividends will be paid. Managers should note that debts may be better controlled by a mechanism in force that managers will pay cash in future.

The following suggestions are offered for the future researchers:

- 1 – If possible, future researchers in the industry to examine the relationship between free cash flow and pay audit fees because the analysis of a particular industry will provide useful information for trade investors.
- 2 – In many developed countries the amount of audit fees are disclosed but in Iran it is not required to disclose the audit fees. Examining the reasons for non-disclosure of audit fees and advantages of exposing the audit fees could be the subject of the future research.
- 3 – Factors affecting audit fees from the perspective of a major shareholder of the company is an important topic for future research. It is suggested for future research to explore the impact of these factors.

CONFLICT OF INTEREST

Authors declare no conflict of interest.

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