

Dissertation Proposal

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“Competition in the Market for Assurance Services”

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This dissertation examines the effects of different competitive structures in the market for assurance services. I attempt to address the overarching question of if the current market structure of public accounting generates maximized levels of audit quality. Specifically, I focus on the unique attributes that characterize public accounting and examine if the current structure produces incentive compatible use of non-audit services, efficient labor allocation, and maximal audit quality. I find that, purely with respect to audit quality, an intermediate level of competition is preferred to both a monopoly or a highly competitive market structure for public accounting. Having a smaller group of high quality firms in the market for assurance services not only promotes healthy competition that generates higher levels of audit quality across the industry, it simultaneously depresses the use of non-audit services, a tool shown to negatively impact audit outcomes. Further, the industry’s current training procedures for new labor promotes a labor flow consistent with large size disparities separating different tiers of auditors.

In the first chapter, I investigate the effect of varying levels of competition as it relates to audit quality. Using empirics, I show that audit quality does not follow monotonically with competition. The results show a non-monotonic relationship between competition and audit quality with the highest levels of average audit quality being produced within markets that are characterized neither by high levels of competition or a monopoly. A market with too few competitors gives auditors little incentive to compete and maximize the quality of their output. Meanwhile, an overly crowded market forces firms to compete based on price or the quantity of services they offer, pushing audit quality away from the forefront. A environment characterized by a few bigger auditors carving out a large proportion of market share, allows firms to extract sufficient current and expected future rents such that long-term viability is their focus and audit quality is prioritized.

In the second chapter, I study the role that non-audit services, a secondary revenue stream, plays in competitive markets. I empirically show that auditors respond to intensifying local competition by increasing their emphasis on, and selling more, non-audit services. This suggests that audit firms utilize their non-audit offerings to differentiate themselves when markets become more crowded. Further, I find that this response is stronger when there is a wide range in the quality of local audit offices, when audit fees are depressed, and when new engagements are subject to lowballing. The sensitivity to the range in quality of local auditors is especially noteworthy given that I discover that this result is largely driven by high quality firms. High quality auditors capitalize on their audit expertise to help push their non-audit services when markets become competitive. On the other hand, the increase in non-audit services production when audit fees are depressed or lowballing is present suggests that auditors feel fee pressure to generate income through non-audit services when their central revenue stream becomes less profitable. This is potentially very troubling when combined with my results showing a negative relationship between non-audit services and audit quality. The results suggest that

overly competitive audit markets push auditors to not only decrease audit fees but also increase their use of non-audit services which degrades audit quality.

In my third chapter, I examine the labor side of public accounting. I show how the centralized training of public accountants directs the flow of trained workers towards larger firms over smaller ones. This structure serves to further exacerbate the gulf between the tiers of public accounting firms and further cement the difference in firm size between the Big 4 and all other competitors. If high ability workers produce a sufficiently distinguishable outputs compared to their lower-ability counterparts, then the most talented workers will naturally flow into either positions at larger accounting firms or into industry. This makes growth extremely difficult for smaller firms as only extremely specialized clients and workers will remain with them long-term.