Dissertation Proposal

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Oligopolistic Competition in the Market for Assurance Services

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This dissertation examines the effects of an oligopolistic competition structure in the market for assurance services. I attempt to address the overarching question of if an oligopoly, structured like the one we observe today, generates maximized levels of audit quality and optimal fee allocations. Specifically, I focus on the unique attributes that characterize public accounting and examine if the current structure produces optimal use of non-audit services, efficient labor allocation, and maximal audit quality. I find that an oligopoly is preferred to both a monopoly or a highly competitive market structure for public accounting. Having a smaller group of large players in the market for assurance services not only promotes healthy competition that generates improved levels of audit quality across the industry but also depresses the use of non-audit services, a tool shown to negatively impact audit outcomes. Further, the industry’s current training procedure for new labor promotes a labor flow consistent with strengthening a long-run oligopoly.

In the first chapter I investigate the optimality of varying levels of competition as it relates to audit quality. Using empirics, I show that audit quality does not follow linearly with competition but rather the relationship between competition and quality is concave. This results with the maximum level of average audit quality being reached within oligopolistic markets. A market with too few competitors gives auditors little incentive to compete and maximize the quality of their output. Meanwhile, an overly crowded market, especially if combined if an opaque output, forces firms to compete based on price or the quantity of services they offer, pushing audit quality away from the forefront. A stable oligopolistic environment 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. 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 the 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 and a positive relationship between audit fees and audit quality. The results suggest that overly competitive audit markets push auditors to not only decreases 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 Big 4’s oligopoly. If high ability workers produce a sufficiently distinguishable output 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 and works to enforce the oligopoly.