

A Theory of Audit Industry Structure

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Abstract:

This paper constructs a theory of audit industry structure under pure price competition. Audit demand is modeled as indivisible and inelastic, and audit production requires two inputs: staff, which can vary freely, and partner labor, which can vary in the long run only. I derive equilibrium audit firm sizes and clienteles that satisfy the requirement that each firm cover the long-run costs of auditing, even though prices are set by short-run price competition. I find that demand indivisibility and capacity commitment suffice to produce industry structures in which audit firms' sizes are proportional to the sizes of their clienteles. In every long-run equilibrium, all incumbents firms earn rents and the rent-minimizing industry structure in this model is a duopoly.

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