State Accountancy Regulations, Audit Firm Size, and Auditor Quality: An Empirical Investigation

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Abstract
This paper extends the literature on occupational licensing by examining the effect of states’ licensing requirements for Certified Public Accountants (CPAs). We related variations in licensing requirements across states to CPA firm based assessments of service quality. Based upon prior research, we also examined the relationship between service quality and a market generated quality indicator: CPA firm size. The results show no association between audit quality and variations in regulatory strictness. However, a positive relationship was found between audit quality and firm size, suggesting that market forces, rather than governmental intervention, is effective in addressing the information asymmetry that can exist between CPAs and their clients.

1. Introduction

Organizations are characterized by numerous agency relationships. These include both internal relationships between top managers and subordinates, and other relationships such as those between managers and shareholders and between the firm and creditors. Establishing contracts such as earnings-based compensation plans and debt covenants can reduce the agency costs created by these relationships. The monitoring and enforcement of these contracts, in turn, create a demand for credible financial reporting. Audits have the potential to enhance financial statement credibility (Jensen and Meckling 1976; Watts and Zimmerman 1983).

Because various parties have an interest in credible audits, assessing auditor quality becomes an important matter. Yet, audit quality is largely unobservable. Corporate managers can assess audit quality only imperfectly by reviewing audit plans and audit scope and by periodically observing the performance of audit firm personnel (Simunic and Stein 1987).

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Third party users of financial statements, such as shareholders and creditors, have even less of an opportunity to assess audit quality. Consequently, an auditing firm has much more knowledge about its capability than do managers and third parties. This information asymmetry creates the need for a mechanism by which managers and third party users can become more cognizant of auditor quality.

Two solutions to this information asymmetry problem are possible. One alternative is governmental intervention via occupational licensing of public accountants. Currently, in nearly all of the 54 jurisdictions in the United States, only duly licensed Certified Public Accountants (CPAs) can perform audits. The primary intention of these laws and regulations is to ensure that audits and related attest services are conducted only by competent personnel. This helps resolve the information asymmetry problem by ensuring that all auditors have the legislated minimal qualifications, and thereby enhances the credibility of financial reporting. Of course, some users of audit services might desire an audit quality level that exceeds the legislated minimum.

Another approach to resolving the information asymmetry problem relies on market forces. Given a demand for audits of different quality levels, auditors have incentives to differentiate their products on that dimension (Simunic and Stein 1987). When product attributes (e.g., quality) are difficult to observe and measure, producers frequently develop brand names or reputations as indicators of those attributes (Barzel 1982). An auditor’s inclination to do this is dependent on earning at least a normal return on the investment needed to establish its reputation. Shapiro (1983) describes such a setting.

For several reasons, audit firm size can potentially be associated with auditor reputation and audit quality. First, large audit firms can take advantage of economies of scale in establishing reputations (Watts and Zimmerman 1986). Second, larger CPA firms have a greater incentive to guard their reputations because of the larger quasi-rents they could possibly lose by performing substandard work (DeAngelo 1981). Also, the partners in large firms have significant amounts of human capital tied to the firm’s reputation (Fama and Jensen 1983). This provides an incentive for mutual monitoring. Thus, firm size could be an effective quality indicator.

Given the substantial costs imposed by accountancy regulations, and the possible existence of a market generated quality surrogate (i.e., audit firm size), it is surprising that only limited research has been devoted to assessing the benefits of accountancy regulations. The purpose of this paper is to examine the association between seven state accountancy regulations and the potential benefit of higher quality auditing services, as reflected by firm-level peer review ratings. The study also assesses the association between audit firm size and peer review ratings. Based on a sample of 281 firms, we found no association between any of the state accountancy regulations and peer review ratings; however, a strong

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2 The 54 jurisdictions include the 50 states, Washington, D.C., Guam, Puerto Rico, and the U.S. Virgin Islands. The terms “state” and “jurisdiction” will be used interchangeably in this paper.

3 Attest services include audits, reviews, and compilations of financial statements. Audits are a detailed examination of the financial statements, including tests of the underlying systems and records. Reviews play a prominent role in corporate financial reporting. Reviews and compilations have a much narrower scope and provide substantially less assurance about the reliability of the financial statements.

4 The costs include, but are not limited to, those borne by new entrants to meet increasingly stringent entrance requirements, costs incurred by consumers in terms of a reduced number of entrants, reduced competition and higher fees, and the cost of the regulatory apparatus.