Available online at www.sciencedirect.com

ScienceDirect

The International Journal of Accounting 50 (2015) 53 – 74

The International Journal of Accounting

# A Copayment Auditing Scheme for Financial Misreporting☆

Shirley J. Ho[a], Sushanta K. Mallick[b,*]

[a] *National Chengchi University, Taipei, Taiwan*
[b] *Queen Mary University of London, London, UK*

Received 10 October 2012
Available online 13 January 2015

**Abstract**

This paper proposes a copayment scheme to prevent collusion in auditing contracts, offering as a solution to financial misreporting. In the copayment scheme, both the client firm and a third party, such as PCAOB, are asked to share the auditing fee. The key feature of the copayment scheme is that the third party's expenses should be funded by the client firm. We demonstrate that the participation of a third party can create an endogenous collusion cost to the client firm, to such an extent that in the equilibrium, the client firm will not make any offer of bribery. Most importantly, the total equilibrium auditing fee is the same as in the bribery-free contract. This result makes an important contribution to the literature in addressing the issues of financial frauds and collusion between the auditor and the client firm within a principal-agent model.
© 2014 University of Illinois. All rights reserved.

*JEL classification:* M4; D86
*Keywords:* Financial misreport; Auditing contract; Bribery

☆ We thank three anonymous referees of this journal for their two rounds of very helpful comments and the editor, Rashad Abdel-Khalik, for his useful comments on earlier versions of this paper. We acknowledge Bruce Rayton and Wade Martin for their comments. This paper was completed during the first author's visit at the IRES of the Universite Catholique de Louvain, financially supported by Belgian Research Programme ARC 03108-302.
* Corresponding author at: School of Business and Management, Queen Mary University of London, Mile End Road, London E1 4NS, UK. Tel.: +44 20 7882 7447.
*E-mail addresses:* sjho@nccu.edu.tw (S.J. Ho), s.k.mallick@qmul.ac.uk (S.K. Mallick).
*URL:* http://webspace.qmul.ac.uk/skmallick/ (S.K. Mallick).

http://dx.doi.org/10.1016/j.intacc.2014.12.002
0020-7063/© 2014 University of Illinois. All rights reserved.

## 1. Introduction

In the early 2000s, a wave of corporate scams brought financial scandals and the liability of auditors to policy debates. The audit firm is supposed to serve as the public's watchdog in ensuring good financial disclosure, but the auditor's actual client is the audited company itself, whose interests concerning disclosure are not necessarily aligned with those of the investors.[1] Hence, the better-informed (than the public) auditors might be motivated to collude with the client firm and give a report of compliance for the clients. For example, the accounting fraud involving collusion between the CUC International and the auditors from Ernst and Young is estimated at around $19 billion.[2]

Hence, how to prevent collusion has become a timely issue for the current auditing system. Among the various propositions (see Acemoglu & Gietzmann, 1997; Lev, 2003), the most intuitive solutions will be to increase both auditors' and client firms' collusion costs. Such solutions would reinforce harsh penalties for reporting frauds according to the SOX act and put an emphasis on the auditors' morality and concerns for their reputation.

According to the SOX act, CEOs and CFOs must personally sign off on the financial statements of their companies. The law includes stiff penalties (up to 20 years imprisonment and/or a US$15 million fine) for executives who knowingly falsify these reports.

As for auditors, Howieson (2005) provides a comprehensive survey of literature about how to teach ethics to auditors and accountants. Our paper attempts to contribute to this line of research by proposing a copayment scheme that requires the auditing fee to be shared by a third party, and we demonstrate that the participation of a third party can create an endogenous collusion cost to the client firm, to such an extent that in the equilibrium, the client firm will not make any offer of bribery. Most importantly, the total equilibrium auditing fee is the same as in the social optimal contract.[3]

This paper proposes a copayment scheme as a solution to financial misreporting. In the copayment scheme, both the client firm and a third party, such as FASB, are asked to share the auditing fee. Most importantly, the total equilibrium auditing fee is the same as in the collusion-proof contract. On October 13, 2010, the EU commission issued the new "green paper" that presents an agenda for audit market reforms in the future. Among the many proposals for modifications, the green paper also recommends changing the procedure of hiring an auditor by explicitly invoking a third party that is responsible for selecting the auditor and designing the audit contract. The copayment scheme proposed here discusses how a third party could help in designing the audit contract and in guaranteeing high audit quality and truthful audit reports.

According to the Generally Accepted Auditing Standards (GAAS), each firm[4] needs to sign an employment contract with an auditor to check on the firm's financial status. Hence, our analysis starts by characterizing the current auditing system in a simple principal-agent model, considering the possibility that if the client firm's financial state turns out bad, the client firm can bribe the auditor to lie (i.e., to collude with the auditor). We show that from the viewpoint of the

[1] See Shapiro (2005).

[2] See Khalil and Lawarree (2006).

[3] The notion of "social optimality" is used here to denote the contract incurring full effort as the social optimal contract to distinguish the optimal contracts offered by the client firm under the current system.

[4] An auditing committee, consisting of independent and outside directors, will oversee hiring and performance of the auditor. However, the payment is still made by the client firm.

Download English Version:

https://daneshyari.com/en/article/1004953

Download Persian Version:

https://daneshyari.com/article/1004953

Daneshyari.com