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Litigation environment and auditors' decisions to accept clients' aggressive reporting

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ABSTRACT

This study contributes to accounting and auditing literature by addressing two empirical questions: (1) whether litigation environment affects auditors' decisions to accept clients' aggressive reporting and (2) whether litigation environment, client business risk, and client retention pressure interact and jointly affect auditors' decisions to go along with clients' preferred accounting choices. Fifty-nine (59) US and sixty-one (61) Hong Kong auditors employed by the Big-4 accounting firms participated in this study. The result shows that litigation environment has a significant effect on auditors' decisions. Auditors who practice in more litigious environments tend to be less willing to go along with clients' aggressive reporting than those who practice in less litigious environments. This study also confirms that there is a significant interactive effect between litigation environment, client business risk, and client retention pressure on auditors' decisions to accept clients' aggressive reporting choices. Implications of the empirical findings for policymakers, standard-setting organizations, and international accounting firms, as well as directions for future studies, are discussed.

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1. Introduction and motivation

The impacts of public policy on the accounting profession through the enactment of laws and regulations have been well-documented and can be traced back to the 1930s.² Among those policies

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² See Zeff (2003a,b) for detailed discussions of those public policies and their impacts on the accounting profession.

enforced, the Sarbanes-Oxley Act (SOX) probably has had the most far-reaching effect on public accounting firms and auditors. As DeFond and Francis (2005) stated, the passage of SOX provided a strong indication that policymakers, regulators, and market participants have recognized the crucial role of auditing in US capital markets. According to SOX, US or foreign public accounting firms³ that issue or furnish evidence to be part of audit reports related to US public companies are required to register with the Public Company Accounting Oversight Board (PCAOB). All registered public accounting firms are to be treated the same way as firms organized and operating under US laws, regardless of their geographic locations or the jurisdictions of audit practices. If they violate SOX, registered public accounting firms are subject to the same legal, regulatory and economic consequences.

Unlike for previously-enacted laws and regulations, US policymakers have deliberately broadened the coverage of SOX to accounting firms and auditors practicing outside of US jurisdictions. There are two primary reasons for this extension. One is that many US multinational enterprises (MNEs) have rapidly expanded businesses into global markets. Such expansions allow MNEs to generate a significant percentage of their revenues from overseas operations.⁴ Since the global business trend is expected to continue, managing partners of MNE engagements, typically from US offices, have to rely on procedures conducted and evidence collected by auditors employed by accounting firms in foreign countries. Therefore, the quality of audit judgments made by professionals practicing in foreign jurisdictions could, in turn, affect the quality of US MNEs' financial statements. Because of this dependency, US accounting firms and managing partners of audit engagements could expose themselves to legal and economic consequences under SOX, if audit judgments made by foreign professionals turn out to be substandard. To address this concern proactively, executives of US accounting firms and managing partners of MNE engagements must understand what factors, and to what extent these factors, may affect foreign auditors' professional judgments.

The other reason for expanding the coverage of SOX to auditors who practice in foreign jurisdictions is that many foreign companies have chosen to list their American Depository Receipts (ADR) in US capital markets.⁵ Since these companies are headquartered in foreign countries, their financial statements are, and will continue to be, audited by auditors who practice outside of US jurisdiction. To ensure the quality of financial statements filed by these foreign firms with the Securities and Exchange Commission (SEC) and used by US stakeholders, it is essential for US policymakers and regulators to understand whether certain jurisdiction-specific factors may cause foreign auditors to reach different audit decisions than are reached by their US counterparts based on the exact same audit scenario. Such an understanding would allow policymakers and regulators in the US to take action proactively to protect stakeholders of foreign companies listed in US exchanges.

Since SOX has reshaped the landscape of US and international accounting practices, DeFond and Francis (2005) indicate that it is important to conduct cross-country audit research because it creates a setting for researchers to investigate the effect of institutional arrangements on audit judgments. In this study, we invited US and Hong Kong auditors to participate in the experiment because they represent professionals who practice in two jurisdictions with distinctive litigation environments. A comparison of decisions made by auditors employed in the US and in Hong Kong allows us to control several important institutional factors, such as legal systems/origins, shareholder rights, financial

³ In this study, we adopted the SOX definition (Section 106(d)) of "foreign public accounting firm" as a public accounting firm that is organized and operates under the laws of a foreign government or political subdivision thereof.

⁴ For example, conglomerates like Colgate–Palmolive, Dow Chemical, Hewlett–Packard, and Xerox have generated more than 50% of their revenues and profits from operating overseas (Shapiro, 1996). These companies also have business operations in more than 40 countries in various global market regions (Qian and Li, 2002). Recently, McDonald also announced that the company experiences significant growth from operations in Asia-Pacific and Latin American regions.

⁵ The US stock exchanges have been perceived as the most prestigious among global financial markets. As of March 23, 2004, 2071 foreign companies trade their American Depository Receipts (ADR) in organized exchanges in the United States. Compared to the number of foreign firms registered with the SEC on December 31, 2001 (1344), this represents a 54% increase over a 27-month period (Bank of America ADR Report 2004). Based on the findings reported by Bekaert et al. (2002), Asian firms raised \$1 in the foreign equity market for every \$3 they raised from their domestic markets during the 1990s. Leuz and Oberholzer-Gee (2006) also indicate that global financing carries significant implications to multinational companies with regard to the availability and quality of their financial reports. At the time of the SOX enactment, approximately 10% of SEC registrants were non-US issuers, commanding nearly 20% of US market capitalization. The homes of these registrants are in 60 countries around the world.

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