

Article

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The Capital Market Effects of Rewarding Auditors for Detecting Fraud

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Abstract

Recent research argues that auditors may be motivated to improve audit quality if regulators reward auditors for detecting fraud. I analyze the effects of such a reward system on the capital market by using a model of three players: an investor, a firm manager, and an auditor. I show that when the regulator starts to reward auditors for detecting fraud, (i) total investment by firms, (ii) firm ownership by outside investors, (iii) audit resource investment, and (iv) managers' welfare increase. These results are in favor of rewarding auditors for detecting fraud.

Keywords: auditing; fraud detection; reward

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