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RELIABLE FINANCIAL STATEMENTS: EXTERNAL AUDITING SYSTEM OR FINANCIAL STATEMENT INSURANCE?

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ABSTRACT
Research Aim: This study reviews the literature to find whether financial statement insurance can be substituted for the current external auditing system.
Design/ Methodology/ Approach: This article reviews how financial statement insurance (FSI) advances external audit independence, reduces audit failure, boosts audit quality, and increases the reliability of financial statements.
Research finding: This study shows that the FSI system assists in mitigating the monetary relationship between auditors and the audited companies by forcing companies to purchase insurance for their financial statements. Accordingly, FSI protects investors against any losses due to any misrepresentation instead of having them audited. In this system, companies hire insurance companies, and insurance companies hire external auditors to assess the insurance premiums and policy coverages through auditing financial reports. Also, it guarantees a lack of any misrepresentation or omission in them.
Theoretical contribution/ Originality: This study contributes to the literature by concluding that financial statements insurance can be an alternative to a current audit system and investigates its usability from the perspectives of the components of the system
Practitioner/ Policy implication: The study results can be useful for investors in the capital markets, companies, audit firms, and insurance companies.
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JEL Classification: M41, M42, G22

1. Introduction

Nowadays business processes have been equipped with new technologies. Therefore, following the Enron scandal in 2001 and subsequently several other ones in many countries, many investors and scholars have criticised the present auditing system (Alles et al., 2018; Ramsarghey & Hardman, 2020). The stakeholders of companies with a lack of trustable auditing system are the primary victims of the accounting scandals since the value of their stocks faced a severe reduction.

Independence is one of the essential factors for external auditors in discharging their auditing functions adequately. Auditors should be financially independent of their clients. However, when the audit company relies on a particular client and develops economic bonds with the client, auditor's independence will be compromised. Up to now, several assumptions indicate auditor independence is under question (Cunningham, 2003; Ugwu & Okoli, 2020).

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Firstly, the auditor must provide investors with information, but the information quality depends on the incentives that the employer (audited firm) provides the auditor with (Salehi et al., 2020; Roszkowska, 2020). Then, the failure of the auditing profession to fulfil their role as independent gatekeepers has been among critical issues in this field (Gelter & Gurrea-Martínez, 2020). The auditors are paid by the firms they audit. Thus, the auditors are dependent on management, who has an influential role in making decisions regarding their compensation and employment (Donoth et al., 2013). As a result, an inherent conflict of interest is created that is endemic to the relation between the auditor (the agent) and the clients-management (the principal) (Knechel et al., 2020).

Secondly, because of large changes that happened in record-keeping technology and the dramatic sophistication of client operations, external auditors must have more knowledge. Acquiring more knowledge is possible by providing clients with non-audit services. The Sarbanes-Oxley Act (SOX Act) of 2002 disallows the auditors from providing non-audit service (NAS) to an audit's client. The motive for this law is the belief that the economic connection of the auditor with the client potentially undermines the auditor independence, and then compromise the audit quality (Tepalagul & Lin, 2015). In this case, it is concluded that if the prohibition is imposed against an auditor in providing clients with consulting services (non-audit services), the auditor acquires less knowledge about the operations of the client. Consequently, less-informed auditors would influence the auditing system. For this reason, audit companies sometimes are forced to offer non-audit services to their clients.

To answer this question, whether payments from firms to external auditors for non-audit services compromise the integrity of the audit process, Frankel et al. (2002) conclude that the payments by the firm for these services can put the auditor's independence at risk (Gillan, 2006).

The previous studies suggest that the magnitude of the non-audit fee (NAF) may diminish the independence of the auditor. Because NASs have some drawbacks threatening independence. The self-interest threat is considered as the first drawback. The reliance of the auditor on the client may become higher when thinking of the future earnings that can be gained through the NASs to the client (Becker et al., 1998). Hence, it is probable that the auditors deliberately neglect the breaches and violations of the client to protect their potential future revenues. However, some previous studies have documented that auditors are less likely to issue a going-concern modified audit opinion for clients that pay higher NAF (Sharma & Sidhu, 2001).

The intimidation threat is the second drawback. This issue is represented by the client's ability to select a different auditor in the future. It is a common threat in the auditor-auditee relationship. However, this threat arises in a situation in which the auditor may also lose payments for the consultancy services (Mayhew & Wilkins, 2003). According to some studies, NAS may diminish the independence when the auditor expects future fees, and when there is the replacement risk in the case of providing non-positive audit reports (Acemoglu & Gietzmann, 1997).

The self-review threat is the third NAF drawback. The auditors' responsibility is to evaluate the internal control and accounting systems. Thus, auditors are evaluating their work, which can affect their independence. Auditors may be unwilling to criticise the work carried out by their consultancy colleagues because the audit firm may lose its lucrative consultancy services (Bartlett, 1991). Therefore, auditors may put their independence at risk due to neglecting the errors resulting from their own firm's advisory services during the audit process.

Therefore, although comprehensive corporate governance standards indicate that auditors are the stakeholders' agents, auditors are engaged by management practically (Ronen, 2014). The motives for compliance with the wishes of management include unspecified future audit payments that would be gained through constant engagement as an auditor, as well as the fear of loss of fees from the audit services. Changes in the audit environment and business that happened over the last decades have intensified the conflict of interests between the auditor (the agent) and the management (the principal) (Ronen, 2003; Faboyede & Mukoro, 2012).

The significance of failures in auditing is more severe in weak economies and where the price of stocks drops. Over the last decades, the frequency, visibility, and extent of "auditing failures" have shown an essential increase. Besides, it should be noted that there has been an association between some noticeable audit failures and the best and largest audit companies. One reason for this fact is the changes in the auditing, accounting, and business nature during the last decades that is a shift from an industrial economy to an information economy. Also, the different characteristics of clients increase significant differences in the number of auditing matters reported (Lin et al., 2019). As a result of this altered environment, the auditors are put in a very tough situation during providing the clients with services, and they are convinced for adopting the opinions of the clients (Ronen, 2003; Faboyede & Mukoro, 2012).

Unfortunately, punishment and prosecution could not adequately prevent misconduct since it is difficult to prove or discover deliberate misrepresentation. It would be socially ineffective and wasteful to redesign the regulatory structure and include observation and supervision measures by the government as long as the management of the firms engages the auditor. Instead, what is required is an agency relationship between the auditor and an appropriate principal whose economic interests are aligned with the goals of providing the high-quality financial statement to the shareholders, who are the ultimate intended beneficiaries of the auditor's verification. Then, complete loyalty to the public's trust would be restored by such a realignment.

According to some studies, this problem can be solved using market mechanisms, through an intermediary who does not benefit from the price of securities. Using such a mechanism may lower the irrational incentives of auditors. In other words, an institutional mechanism is required to eradicate the conflict of interests of auditors and align their motives with stakeholders' motives correctly (Ronen, 2003). In the context of a free market mechanism, few scholars have previously proposed a solution called Financial Statement Insurance (FSI) mechanism. FSI can serve as an intermediary and help improve the aligning of incentives. It leads to higher audits quality accordingly. However, there is not enough literature and discussion about FSI compared with current external auditors. Therefore, in the present study, the authors aim to review past studies regarding FSI to find whether FSI can be substituted for the current audit system.

2. Literature Review

The agency theory postulates that external auditors act as a control tool to eliminate or signal on opportunistic practices or fraud committed by management as earnings management (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). Moreover, external auditors audit the financial statements and lend credibility to published financial statements. They provide reasonable assurance that investors receive relevant, useful, transparent, and reliable financial information in making sound business decisions. Agency theory suggests that in the absence of regulation, firms' demand for independent audits is a function of the extent of the separation between ownership and control (Rezaee, 2004). Fan and Wong (2005) also support this statement and claim that external auditors have a monitoring responsibility to diminish agency problems. In this regard, as a characteristic of audit quality, the independent external auditors assure the shareholders about the financial statements' quality (Rezaee, 2004).

However, one of the crucial assumptions of the current auditing system is auditors' independence (Ugwu & Okoli, 2020). Audit independence and security issues look at accountants and auditors. The auditor is most often appointed by executives who have an overwhelming influence on them. Even in private companies, there are many problems regarding auditor independence (Gelter & Gurrea-Martínez, 2020). Moreover, the inability of audit firms to perform their duties properly leads to negative externalities. These issues are due to the potential for financial loss to investors and, more importantly, a lack of trust in the system. After financial scandals, investors may generally be sceptical about investing in listed companies (Enriques & Gilotta, 2014).

The information disclosed in financial statements has public good character, meaning that the issuer and its investors do not fully internalize its benefits. Due to the impact of Network resulting from the comparison of financial statements and the integrity of the entire system, the amount of information without binding rules is probably not socially optimal. Therefore, companies may not have the incentive to devote themselves independently when choosing an auditor (Hanh, 2021). However, this does not completely free accounting and audit staff from crude business accusations.

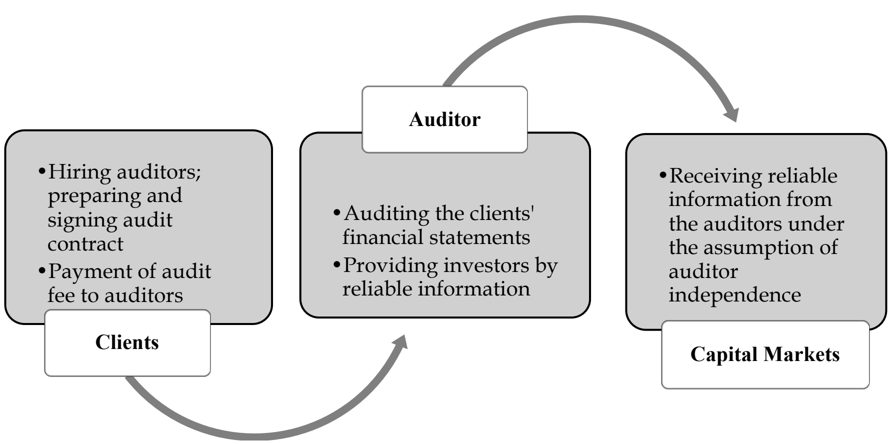

Figure 1 The Audit Process in the Current Audit System (Eilifsen et al., 2014)

In this regard, Moore et al. (2006) classify some of the characteristics of the current audit system that threaten auditor independence. First, audited firms are in some sense employers to audit firms who employ them whenever they prefer. Second, firms are potential employers of audit firms' personnel. Third, audit firms usually provide audited firms with non-audit services such as consultancy. Because of these matters, these days, the current audit system came under criticism for its auditor independence. The process of the current auditing system can simply be shown in Figure 1.

Various alternatives to the current audit system have been addressed to eliminate or at least minimise factors that threaten auditor independence. Hatherly (1995) discuss the auditor independence problem for the UK audit system and list possible solutions. The proposed solutions include establishing audit committees within company bodies and setting up institutional bodies to enhance the auditing system. Alternative solutions among many others include the Corporate Governance Board (Murray, 1998), Shareholder's Board and Corporate Senate (Turnbull, 2002). They are proposed to regulate the relationship between managers, investors, and auditors (Yukcu & Ozkaya, 2008; Eilifsen et al., 2014).

Auditor independence has been addressed by reforms in PCAOB's and Sarbanes-Oxley auditing standards address through the inclusion of supervising in the audit committee rather than in management, restricting non-audit services and improving oversight (Meuwissen & Quick, 2019; Keyser, 2020). Thus, audit failure can be reduced. However, still, the auditor is paid by companies. Besides, though auditing reports on internal control could give narrative disclosure from auditors regarding financial statement reliability, a statistical measure of reliability may not be provided by them that enables inter-company comparisons.

Moreover, Loewenstein et al. (2002) state that audit failures are assumed to be conscious behaviours, while regulations might aim at removing this "conscious" misbehaviour. However, based on their experiments, they conclude that since the biases inherent in auditors' judgments are not conscious, they cannot easily be corrected. Besides, as auditors' relationships with their clients get closer, their biases get stronger (Ugwu & Okoli, 2020). Therefore, it is required to make a more radical and comprehensive change in the entire system, such as the assignment of auditors by the governments and establishing a market for audit quality (Yukcu & Ozkaya, 2008).

According to Ronen (2003), no external force (e.g., regulation, enforcement, or legislation) could reasonably solve the inflexible conflict of interests. Ronen (2014) believes that an agency relationship should be created between the auditor and a suitable principal–a principal that has economic interests aligned with the investors' economic interests, as investors are the ultimate beneficiaries of the auditor's tasks. For responding to the question that who (in a free market mechanism context) could assign the role of this proper principal, Ronen (2014), Cunningham (2003), and Palmon and Sudit (2000) explain the FSI system as an alternative solution. Moreover, Ronen and Cherny (2002) state that substituting the auditors' financial source from audited firms to another party can eliminate the overly criticised conflict of interest and the issue of the auditors' dependence (Ozkaya & Yukcu, 2008). As a result, it is possible to consider the insurers as a reasonable option. As argued by Ronen (2002), this market-based simple solution would also significantly improve auditing quality and return the public fading confidence to auditors.

2.1. What is Financial Statement Insurance?

Discussing the real independence of the auditors is not possible as long as there is a conflict of interest between the auditors and the investors. FSI system attempts to eliminate this conflict of interest and enhance the audit quality. This system would change the principal-agent relationship significantly. The basic structure of FSI can be described as follows. Instead of assigning and giving payments to auditors, companies buy FSI, which offers covering losses resulting from financial reports' misrepresentations (Ronen, 2003). The main characteristics of the FSI plan include shifting decision-making authority on the employment of auditors from the clients to the insurer; and the impact of publicizing the charged premium. Under the FSI system, insurance companies hire auditors and pay them to verify the reliability of their clients' (insured companies) financial statements. When the quality of a company's financial statement is high, insurers trust them through the assessment of the financial statement that has been done by the hired auditors. Then, insurers issue the policy with high coverage and a low premium for those companies. Therefore, companies can obtain publicized insurance coverage to pay the premiums based on those coverage. The companies that announce higher coverage and lower premiums would be distinguished in the investors' eyes as the firms that have financial statements of higher quality. Contrarily, the companies that have lower or no coverage or larger premiums would be revealed as the companies that have a poorer quality of financial statements. All companies are willing to get larger coverage and pay lower premiums for fear of being recognised as the latter case (Ronen, 2003).

As part of the FSI, the auditor is employed and paid by the insurer. It means there should be no monetary connection between auditors and insured companies that are audited by the auditors. Therefore, the auditors' independence is enhanced. Then, auditor independence leads to high audit quality. Because auditors are responsible to the insurer not to companies. That is why insured companies may not force auditors to present clear reports about their financial statements. In other words, the auditor would have the responsibility to verify the accurateness of the financial statements of companies that are the potential insurance companies' customers. It is expected that providers of FSI have a list of approved auditors that the companies can choose an auditor from this list. However, it is anticipated that the auditor owes his/her loyalty and duty to the insurer for two factors. First, it is the insurer that pays the auditor, and thus, the auditor focuses on his efforts towards protecting the insurer. Second, it is rational to suppose that auditors provide auditing services to more than one of the insureds of the insurer. Therefore, a situation is created whereby an expensive "audit failure" would endanger the relationships of the auditor with the insurer, which results in losing other audit projects (Dontoh et al., 2013).

Based on the literature, audit firms should not perform non-audit services for their clients in some countries due to achieving external audit independence. Even, in some cases, they are mostly prohibited from providing their clients with non-audit services (Tepalagul & Lin, 2015; Meuwissen & Quick, 2019; Keyser, 2020). However, in the FSI, the auditing company is not essentially banned from performing consulting services for any insured; it is a case of taking permission from the insurer. It can be stated that it is in the best interest of the insurer to authorise performing consulting services. Because when the knowledge of the auditor on the insured's operations and systems is higher, then he or she can better fulfil the assigned audit (Lin et al., 2019). Thereby, the insurer's risk can be reduced. Insurers' objective is to mitigate the claims against themselves for audit failures. That is why they evaluate the remuneration of the auditor. Therefore, if FSI becomes prevalent in both the private and public sectors' companies, it can be expected that the pool of respected and qualified auditors would grow. Because auditors believe that it is in their benefit to step toward professional excellence in a struggle to gain more audit projects thus competition is created for excellence in the CPA profession (Ronen, 2003). Moreover, the insurance company is responsible for motivating auditors to perform auditing with high quality through various means of sanctions and incentives.

2.2. Financial Statement Insurance Procedure

The FSI procedure initiates reviewing the prospective insured. An expert risk assessor reviews on behalf of the insurer. The expert risk assessor discovers the conditions' nature, like the following cases for assessing the misrepresentation risks in financial statements and the loss amount resulting from such misrepresentations (Ronen, 2014): (i) the nature, competition level, strength, and overall economic health of the industries in which the prospective insured acts; (ii) the trustworthiness, operating reasoning, reputation, prior operating outcomes, and financial report of the prospective insured's management; (iii) the age, nature, operating structure, and size of the prospective insured; (iv) the effective management, accounting standards, control environment, procedures, and practices of the prospective insured.

According to (Ronen, 2014), the FSI process can be explained as below:

i. The prospective insured demands an insurance proposal from the insurer. The proposal comprises the maximum insurance amount offered and the associated premium covering both the audit cost and insurance premium. Essentially, a coverage plan below the maximum and related premiums is also specified. The request for the proposal is made before preparing the prospective insured's shareholders' proxy based on the endorsing review. The reviewer may be the same auditor that audits the financial statements.
ii. The choices below are offered by the proxy:
   a. The maximum insurance amount and associated premium as proposed in the insurance proposal.
   b. The insurance amount and associated premium proposed by managers.
   c. No insurance.
iii. After approving one of the choices in the second step, the auditor and reviewer cooperatively make a plan for the depth and scope of the audit.
iv. After the audit, the policy would be issued if the auditor is in the status of delivering a clean opinion. If the auditor's opinion is qualified, the insurer will provide no coverage. The exception is that the company can renegotiate with the insurer regarding various terms, depending on the

auditor's reasons and results of qualification. Afterward, the new agreement will be publicised.

v. The auditor's opinion comprises a paragraph demonstrating the insurance amount covering the financial statements and the related premium.

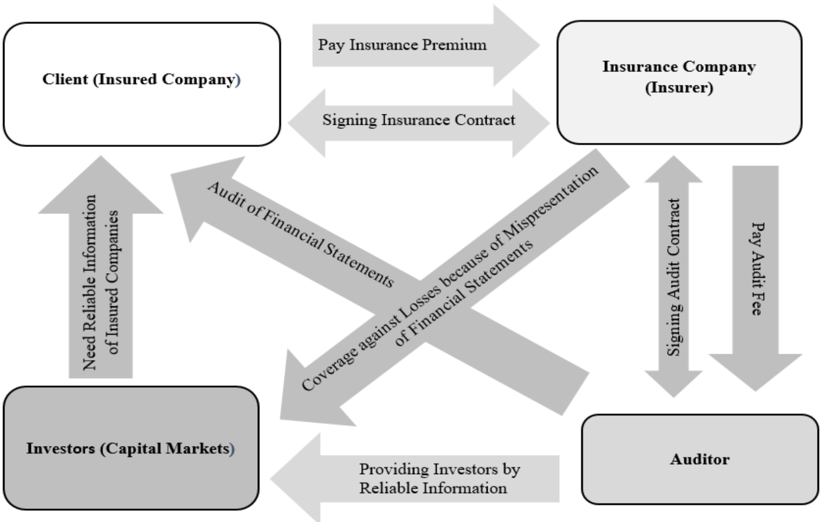

Figure 2 Financial Statements Insurance (Proposed System) (Yukcu & Ozkaya, 2008)

Besides, the FSI concept contains an effective claims agreement procedure. A fiduciary organization is cooperatively selected by the insurer (Insurance Company) and the prospective insured. This organization must represent the financial statement to the users when making a claim. One responsibility of the fiduciary organization is evaluating claims before informing the insurer. Following notifying a claim to the insurer by the fiduciary, an independent expert is mutually selected by the fiduciary and insurer for providing a report as to whether there is a misrepresentation or omission. During a short time following the reception of the expert's report, the fiduciary is compensated by the insurer up to the face amount of the policy for the loss (Dontoh et al., 2013). The way the FSI influences the decision-making process of its participants is described in detail. These participants include the insurer, the auditor, the capital market, and the insured. The relationships among the parties are shown in Figure 2.

2.3. The Insurance Companies-Insurer

With extending coverage at an established premium, the insurer's objective is minimizing its claim loss. Simultaneously, probable losses of the stakeholder are also minimised by this objective. Thus, the insurer's interests align with the stakeholders' interests (Peng et al., 2014). By aligning the insurer's interest and the auditors' interest paid by the insurer, the auditors' interest and investors' interest are indirectly aligned.

For assurance of keeping or increasing market share, any firm wishes to reduce the premium for a specific coverage amount that it provides to the insured. This motif is the competition force in insurance firms. Additionally, due to the contrasting market force, the insurer is induced to charge an adequate and accurate premium for covering the costs of the probable claim and other expenditures planned to be compensated for and executive services provided by the insurers (Tarus, 2014). Otherwise, the insurer could not survive if the premium amount is not high enough (Ronen, 2014).

The competitive pressures for minimizing the premium, the contrasting market forces, and the survival motive, warrant the insurer's efforts for computing a premium with the highest accurateness for effective competition with competitors (Yates, 2005). Due to this impulse, the insurer would plan an ideal incentive scheme motivating the hired external auditor or risk assessor for the audit or the review with expertise and to guarantee a lack of any misrepresentations or omissions. In consequence, motivation would be created for the assessor or auditor to reduce misrepresentations that are the cause of possible loss to the principal (the insurer) of the assessor or auditor (Mala & Chand, 2015). Therefore, the insurer is protected by two monitoring layers: the preliminary risk review and assessment, which helps determine the cautious coverage and the related premium, and the external audit, which ultimately specifies the effectiveness of the tentative agreement (policy) (Dontoh et al., 2013; Ronen, 2014).

The sequence of activities is needed by (1) the necessity for contracting at the fiscal year's beginning on coverage and premium so that they can be publicized and made accessible for the investors for assessing the financial statements' quality and share price (due to investment decisions), and (2) the necessity for conducting the external audit, to assure lack of misrepresentations' material which cause probable loss (Healy & Palepu, 1993; Drake & Fabozzi 2012). The external audit plan is organised by consulting with the principal (the insurer) and the risk assessor that carried out the preliminary review to tailor the plan details to the findings of the preliminary risk review (Ronen, 2014).

Another issue from the viewpoint of insurance companies is who will ensure the financial statements of insurance companies (Anam, 2020). Typically, as long as self-insurance is prohibited, there will be no conflict of interest and biases. A cross-matching of insurance companies might be a solution. For those who argue that cross-matching of insurance companies can create moral hazard problems, insurance companies' insurance can be done by a central insurance company funded by insurance companies jointly but operated by the central government (Yukcu & Ozkaya, 2008).

2.4. The Audit Firms-Auditors

It is most likely that audit companies and auditors are the first ones who disagree with a probable change in the audit system. Although their employers suddenly change from managers of the companies to insurance companies, auditors should consider that the job volume of the market does not change. Insurance companies need auditors' expertise to perform risk management to ensure the financial statements of companies and determine the premium. Moreover, the insurance company must hire an audit company to attest to the reliability of financial reports (Yukcu & Ozkaya, 2008).

In the present auditing system, there is no alignment between the interest of the auditor and the interest of stakeholders, rather his management's interest is reflected. Managers in this regime argue with auditors to verify the incorrect assumptions (Prawitt et al., 2012). Because of the auditor's motivations, which are affected by the fear of losing future revenues of auditing to the client, the auditor independence is undermined. Then, they may give the client the benefit of the doubt (Tepalagul & Lin, 2015).

On the contrary, with the recommended system (i.e., FSI), the auditor is hired and paid by the insurer. This system eliminates the monetary connection between auditors and management. Therefore, it will lead to auditor independence which enhances audit quality. Moreover, due to the incentive structure realigning the interests of the auditor and insurer, the auditor is inclined to maintain a higher verifiability level. Indeed, they do not comply with the commands of management, but try to protect the insurer. The auditor would be identifying with the individuals or institutions that would encounter a loss due to an omission or misrepresentation in the financial statements. Such a higher degree of insistence on verifiability might not be welcomed by management; however, from a capital markets perspective, it could not be a bad outcome. Overall, the system should create a greater balance between the requests of financial statement users and risk-taking (Ronen, 2014).

With the FSI, the auditor improves the audit quality to get more anticipated compensation. Since the insurer designs the compensation pattern, the auditor makes decisions on the quality that is ideal from the point of view of the insurer and stakeholders (Beiragh et al., 2020). Precisely, the auditor will try to increase the difference between the revenue of audit fees gained from the insurer and the probable cost of omissions and misrepresentations. There are significant penalties in the hands of the insurer for deterring the auditor from deviation from the desired quality. In the present audit system, a bad audit could result in losing the engagement of the client and some probable litigation expenses. However, with the recommended system, the auditor encounters two types of penalties caused by the audit failure. The first penalty is his offence liability under the contractual relationship between him and the insurer. The second one is the risk of loss of the reputation and many potential clients the insurer can propose for auditing (Ronen, 2014).

Under the current audit system, audit companies generate income besides audit business as well. Consultancy services, besides auditing services, have been a significant area of development for audit companies. The percentage of consultancy services revenues has been increased in audit companies' overall profit (Moore et al., 2003). This non-audit relationship between audit companies and their clients is among the reasons to criticise auditors' independence, which is emphasised by corporate governance. However, under the FSI system, non-audit business relationships will have no adverse effect on audit quality. Thus the possibility of the prohibition of these jobs will be removed (Yukcu & Ozkaya, 2008).

2.5. The Capital Markets-Investors

Another benefit of the FSI system is that it will increase investment in the capital markets due to enhanced investors' confidence in the credibility of the financial statements. Investors will make their decisions on more reliable accounting data. Also, the confidence conveyed from companies to investors motivates them to invest more in capital markets (Yukcu & Ozkaya, 2008).

Two additional dimensions regarding FSI affect the securities: 1) the coverage stakeholders can claim upon the probable omission or misrepresentation, and 2) the financial statements' reliability, as shown in the premium for specific coverage. If the stock market is considered the semi-strong effective, openly available information (publicised coverage and premium) rapidly and unbiasedly influences the share value. With such more precise pricing of the securities, more accurate signals would be provided to individual and institutional investors. Accordingly, they are helped to channel their capital and savings to worthy projects more effectively. The investors are concerned about the limitation of the policy coverage and pay less for the securities that have smaller coverage. Therefore, in this way, they protect themselves against misrepresentation risks (Ronen, 2014). Firms that undertake more promising ventures have the ability to the more reliable and credible transmission of information regarding these ventures' potential to the markets and obtain funds for financing these ventures more easily and cheaply (Cumming & Johan 2013). Then, more efficient resource allocation would be obtained and social investment would result in a larger return (Ronen, 2014).

The conditions needed for a signalling equilibrium would be met by the FSI mechanism. When the insured purchases a larger coverage, the premium that should be paid by the company is larger; however, for any specific coverage, when the financial statements' quality is better, the insurer will assess a lower premium. When the internal auditing and accounting controls are more effective and there is the corporate governance system, it is more probable that the assessor appointed by the insurer calculates smaller risk, which results in assessing a lower and more accurate premium by the insurer (Arwinge, 2014). Therefore, when the financial statements' quality is higher, the paid cost by the insured companies for a specific coverage becomes smaller. Consistently, for a fixed premium, insureds with higher quality financial statements can purchase more coverage. Then, the market can compare different firms and estimate which one offers financial reports with higher reliability. Considering the market's semi-strong efficiency, it is possible to price these different qualities into the securities presented by the insureds to the public or those dealt with in the secondary markets (Skipper & Klein 2000; Ronen, 2014).

2.6. The Company-The Insured

Companies try to balance their request for larger returns against the evading of punishment by the capital markets for unreliable numbers in the presented financial statements. A company with higher-quality financial statements tends to indicate its superiority to the market. To this end, it shows its power of gaining broader coverage with a smaller premium than other companies in its industry. Consequently, the company's securities will be valued at a larger price, thereby reducing its capital cost and increasing its capacity to finance valuable projects. Companies with lower quality financial statements are forced to disclose the lower reliability and quality of the financial reports since they cannot gain the same coverage as the firms with higher quality financial statements. Unless these companies pay a higher premium proportionate with the lower quality the assessor would have revealed. The reason is that they remember that assessing risk by the insurer's agent would lead to a larger premium. A firm that has lower quality financial statements is not able to pretend to be one of the better companies. In this regard, the necessary discipline would be imposed by the insurer by forcing the management and internal controls of the company to be reviewed to extend the coverage and determine the premium (Palepu et al., 2020). Additionally, if a clean opinion is not issued by the external auditor, the coverage is not extended. Thus, they try in the best interest of improving their internal auditing and accounting controls for being qualified for the larger coverage and the smaller premium. It means these companies can now have competition with better companies by truly enhancing their systems in markets (Ronen, 2014).

Under the current audit system, comparability of financial statements in terms of their reliability is not possible. Each financial statement granted a clean opinion is considered equally reliable even though this is not always the case. However, the FSI system in which the insurance premium is paid for a specified coverage limit will address investors which company has more reliable financial statements. This comparability may induce competition among companies to prepare more reliable financial statements (Yukcu & Ozkaya, 2008).

2.6.1. Coverage of the Policy

Premium-Coverage Mix: As to the premium-coverage mix, it is based on evaluating the financial misstatement risk of a company through its hired auditor. It comprises inspecting the company's historical reporting practices and controlling the environment, accounting complexities, and judgment. The resultant index would be most beneficial to the extent it represents this risk assessment (Cunningham, 2003).

One of the challenging issues in the FSI system from the viewpoint of insurance companies is whether insurance companies can cover probable losses in case of a decline in the value of the company due to any mispresentation of financial statements. Ronen (2014) argues that they do, especially when the unique hedging opportunities of insurance companies are considered in the FSI system. Insurance companies can buy a put option for the period stated in the insurance agreement. The condition that put option can be exercised will be the decreasing of the value of the underlying insured company as a result of a mispresentation of financial statements. These kinds of special put options will be cheaper than the regular option agreements where the condition of exercising depend on the price (Yukcu & Ozkaya, 2008).

An essential consideration in the FSI scheme is the extent of potential liability arising from misrepresentations of financial statements. The subject is whether losses resulting from misrepresentations are possibly too large to be covered by insurance firms or not. It should be noted that FSI does not promise to recover all of the losses of investors in the case of misrepresentation of financial statements. Under the FSI mechanism, losses of stakeholders would probably be less due to the higher quality of audit and the incentives, and the companies have to increase their financial statements' quality for reducing their capital costs, which persuade them for specific coverage to minimise premium through the improvement of quality of the financial statements. It is strengthened by the higher quality audits produced by the incentive alignment of the superior auditors (Ronen, 2003).

Moreover, it should be noted that not all companies (and thus, securities) convey the same financial statement risk: some are better than others. Therefore, the portfolios may be constructed with diversification on the financial statement risk's dimension: one security's contribution to the portfolio's collective financial statement risk is smaller than its own financial statement risk (Ronen, 2003).

2.6.2. Claims Process

Many policy terms related to the claims process should be taken into consideration for evaluating and promoting FSI's effectiveness. The crucial matter on the scope of the claims is that policies should be occurrence policies, not claims made. In other words, they cover some financial statements for a period of time in the future. In comparison, claims-made policies cover claims made within a specific period of time regardless of the time they arose. Many other policy terms should be specified, to enable the effective working of the claims process. These terms include 1) announcement from any reliable source; 2) an investor representative elected in the policy should be authorised for prosecuting activities; 3) certain insurer defences should be restricted, including the fortuity requirement and application fraud; and 4) insurers should be indebted good faith responsibilities to investors, not firms (Cunningham, 2003).

3. Methodology

This narrative review was conducted to identify the studies that describe our problem of interest. Narrative reviews have no predetermined research question or specified search strategy; instead, they only consider a topic of interest. They are not systematic and follow no specified protocol. No standards or protocols guide the review. A narrative or traditional review can be an essential part of the research process and help establish a conceptual framework and focus or context for research (Baker, 2016; Demiris et al., 2019). The conceptual framework is defined as a network of linked concepts that together provide a comprehensive understanding of a phenomenon. The conceptual framework of this review paper is presented in Figure 3.

4. Discussion and Conclusion

Concerning financial reporting quality, a market-based solution is presented by FSI, acting as an efficient check on preparing financial statements with low quality. First, by shifting decisions on hiring the auditor to the insurer, this system eliminates auditors' intrinsic conflict of interest. Second, the insurance coverage publicized and premium paid reliably indicates the insured's financial statements quality and direct investments towards better projects. Simultaneously, by signalling the financial statements' quality, companies would be provided with incentives for improving their financial statements' quality. Hence, with improved of audit quality, FSI would lead to less misrepresentations and, therefore, fewer suits and losses for stakeholders.

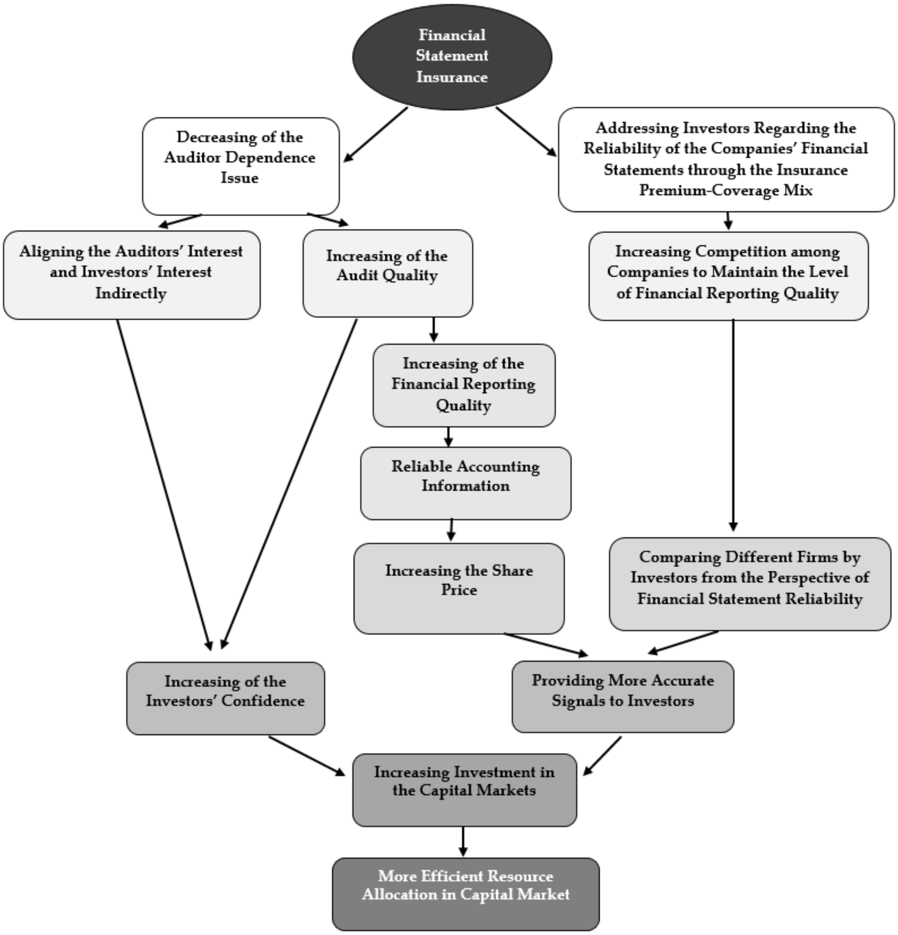

Figure 3 Proposed Conceptual Framework by the Authors

This study reviews the literature and concludes that FSI can be an alternative to a current audit system and explores its applicability from viewpoints of the components of the system, namely; insurance companies, investors, companies, and audit firms.

The part of the system with the greatest benefit will be the insurance companies. FSI creates a completely new business area for them and enables them to increase their portfolio and then create a more powerful insurance industry. One of the drawbacks of the system for insurance companies is whether insurance companies can compensate for probable losses. The proposed solution for this problem is screening the risk by optional agreements.

Another beneficial consequence of the FSI system is that it will contribute to the capital accumulation in the markets by increasing investors' confidence in the reliability of the financial statement. Investors will make their decisions based on the reliability of accounting data. The investors' confidence in the reliability of financial statements motivates them to invest more in capital markets. More precise share pricing through the premium-coverage mix provides accurate signals to investors in investment decision-making. In other words, the market can compare different firms and estimate which one offers financial reports with higher reliability. Then, more efficient resource allocation would be obtained in the capital market.

The FSI system will motivate public or private companies to prepare more reliable financial statements. Under the current audit system, investors may not be able to compare companies' financial statements in terms of reliability. Each financial statement that was granted a clean opinion is considered reliable by investors. However, the FSI system in which the insurance premium is paid for a specified coverage will address investors with more reliable financial statements. This comparability may induce competition among companies to prepare more reliable financial statements and attract more investors. Besides, companies use the FSI as a tool for competitive advantage to generate less costly capital from investors. Broader coverage with a smaller premium causes the company's securities to be valued at a larger price. Hence, the capital markets' reinforcement will help companies access cheaper capital and be financed with less debt in their capital structure. This function of the FSI system is particularly crucial for emerging markets.

According to conventional wisdom, the conflict is raised when auditors are paid by clients as an inevitable fact of life. In response to the lack of audit independence and conflict of interest of auditors, under FSI, companies should purchase insurance policies that provide coverage to investors against losses suffered as a result of misrepresentation in financial reports. Thus, the insurer's interests are in line with the stakeholders' interests. The insurer, who undertakes the risk then hires and pays the auditor for conducting auditing works, which makes the insurers (not audit committees or management) as boss of the auditor. By alignment of the insurer's interest and the auditors' interest, the auditors' interest and investors' interest are also indirectly aligned. When insurers, and not those companies audited by auditors, pay the auditors, this would reduce the conflict of interest inherent in the auditors-client relationship and some unethical practices by the auditors. Therefore, it leads to auditor independence and then improvement of audit quality (Ugwu & Okoli, 2020). Additionally, the power of auditors is higher to impose pressure on managers for applying accounting policies. Accordingly, it promotes financial statements with higher reliability. Moreover, audit companies will have to build new relationships with insurance companies. Although such a relationship might create resistance from audit companies, they will also have the advantage of doing their consultancy business freely and unquestioned. When it is possible to apply the FSI system, it should be kept in mind that the total job volume of auditing will not change, but it will help reallocate the market shares. Traditional auditing leads to a standardised audit report that does not provide statistical or comparative information concerning the reliability of the financial statements. Except in the uncommon cases when auditors provide qualified or adverse opinions, exactly the same thing is said by all audit reports. Under FSI, financial statement reliability is explored by insurers, and this is reflected in the policy premium they charge a particular firm for a specific level of coverage. A transparent financial statement reliability index is created by this premium-coverage mix, which provides users of financial statements with acceptable public information regarding the financial reporting quality of a firm (Cunningham, 2003). Moreover, according to the rules in some countries, audit firms are not permitted to provide companies with non-audit services. In contrast, under the FSI system, all audit firms can present non-audit services to companies under their auditing services. Then, in the proposed system, the total revenue of audit firms can be increased.

It is not claimed that FSI is perfect. Some imperfections could reappear in different forms. However, due to some above-mentioned contributions, the frequency of manifestations is shrunk. As an example, with FSI, insurers and their hired auditors are encouraged to distinguish and modify revealed irregularities in the audit of any given year. Nevertheless, they could be tempted for suppressing detections found in later years covered by a previously issued policy. Under the present system, auditors encounter these temptations. The contributions of FSI can cause that such situations occur less frequently (Cunningham, 2003). Skimming is the other concern, which is the risk of competition among insurers for increasing premium volume by proposing lenient audits. Here also, associated opinion-shopping might happen under the present audit system. Under FSI, even if insurers like to impose this strategy, auditors will again encounter reputational, professional, and SEC restrictions that should interfere with such practices (Cunningham, 2003).

Although the mentioned concerns are real and undermine FSI's application, overall FSI is not a threat for exacerbating the current system, and it can alleviate present imperfections in many important ways. Despite holding considerable promises by FSI, it is courageous and somewhat radical, so the present study confirms proposing it on an experimental basis. Moreover, it is recommended to make it optional rather than mandatory since the cost-benefit calculus could be different across companies and for different capital structures or stakeholder groups.

Radical changes cannot be done easily. There is no matter these changes occur at a personal level, organizational level or national level. Maintaining the status quo almost always seems more appealing given the higher level of uncertainty the new system will bring. These biases blended with the lobbying effects of influential interest groups and the political concerns of decision-makers make the change even more difficult. Applicability of the FSI system in the world is subject to constraints. Consequently, alternatives to the prevalent audit system must be discussed and the beginning point of discussions are academic platforms. Although all available alternatives should be evaluated and considered thoroughly, FSI is one of the first among to be considered.

According to what is presented by this study, it can be concluded that auditor independence needs to be improved. The regulator can only attempt to improve it by, for instance, punishment and prosecution to prevent the misconduct of auditors, requiring companies to activate the role of CG mechanisms in the financial reporting process, observing and supervising by government, and redesigning the regulatory structure. In general, some recommendations may contribute to enhancing the audit independence, increasing the effectiveness of the external audit system, and then improving the reliability of financial statements. FSI is one of the strategies proposed in this context. Therefore, this study recommends regulators, standard-setters, and responsible agencies to:

i. Increase the understanding of the concept of external audit mechanisms and their responsibility in developing the reliability of financial statements.
ii. Revise requirements and apply practical guidelines to maintain a higher level of audit independence.
iii. Highlight the importance of the influence of audit independence on the reliability of financial statements.
iv. Enhance the auditor's independence by an alternative mechanism such as FSI.

This study reveals that FSI may be associated with the reliability of financial statements by enhancing audit independence as one of the attributes of an external auditing system. Several attributes could be relevant to audit quality. However, they are not covered by this research. Therefore, this paper opens up some avenues for further research. There are several measures to develop external audit quality that may impact the reliability of financial statements. For instance, a future study could include the characteristics of audit firm size, audit fee, audit tenure, and industry-specific auditor concentration.

This study would also be extended by exploring FSI and its relationship with financial reporting quality based on fundamental and enhancing qualitative characteristics of accounting information. Therefore, researchers can investigate the association between FSI and financial reporting quality using alternative measures for accounting information quality (e.g., faithful representation, relevance, verifiability, and understandability).

A comparative study can be conducted in a country in terms of the relationship between FSI and the reliability of financial statements from one side and the association between the current audit system and the reliability of financial statements from the other side. Furthermore, the comparison could be extended to become an international study by including other countries from different areas and different institutional and government settings to provide understanding into various markets responses to FSI and the reliability of the financial statement.

Eventually, Future scholars can investigate the influence of the substitution of FSI for the current audit system on different aspects of financial reporting quality through the positivist perspective and using quantitative evaluation methods. Collecting data can be done through the questionnaire (primary data analysis) or some databases (secondary data).

Further research might also produce more and detailed analysis by applying qualitative techniques to help understand how FSI mechanisms are associated with the financial reporting quality of the firm. In other words, in addition to the positivist paradigm, future scholars can analyse this topic from the interpretative or critical perspective. Overall, such a strategy can provide a more detailed description and comprehension of the audit independence's problems and FSI's substitution.

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