

Financial Statement Insurance Will Best Ensure Auditor Independence

By Joshua Ronen

A seemingly unending series of accounting scandals has grabbed headlines during the last few years, eroding public confidence in the accounting profession and leading to the most sweeping amendments to U.S. securities law since the securities act was passed by Congress in 1934.

The Sarbanes-Oxley act of 2002, as well as the Public Company Accounting Oversight Board (PCAOB), established as a result of the Act, forced the profession to rethink its principles and practices. But will the Act and the PCAOB effectively ensure auditors' independence, uphold the auditing profession's integrity, and improve the quality and content of the audited financials?

It is doubtful that merely requiring the audit committee to oversee the audit process will guarantee independence. After all, it is not at all certain that audit committee members themselves can be truly independent: they wish to be re-appointed to their positions; good relations with the CEO also bestow valuable benefits beyond the immediate monetary rewards, including but not restricted to social connections, prestige, etc.

Rather than monitoring auditors to assure their independence, it is far more effective to eliminate their incentives to acquiesce to management's unjustified beautification of the financial statements. This can be implemented by a market-based solution — financial statements insurance (FSI), which would significantly change the principal-agent relationship between the auditor and the client. Instead of the company appointing and paying the auditor, the company would purchase FSI. This insurance would provide investors and creditors, to the extent of the insurance coverage, financial compensation for misrepresentations or omissions in financial statements. As part of FSI, the insurance carrier would retain and pay the auditor. FSI providers would have a list of approved auditors from which a company can select an auditor.

Nevertheless, it is expected the auditor would owe duty and loyalty to the FSI carrier for at least two reasons. First, since the FSI carrier pays the auditor, it focuses the auditor's efforts towards the protection of the carrier. Second, any given auditor likely would be providing audit services to more than one of the FSI carrier's insurance clients creating a situation whereby a costly audit failure would jeopardize the auditor's relationship with the FSI carrier, resulting in the loss of other audit assignments.

The FSI cycle begins with a company approaching a carrier to secure a proposal for financial statement insurance. The proposal would contain two amounts: the maximum amount of insurance the FSI carrier is prepared to provide as well as the related premium.

The premium would cover both the insurance premium and the cost of the audit. Both the coverage amount and the premium would be made public.

The FSI carrier would send its agents to the potential insured company to assess the risk of misrepresentations and omissions in financial statements and the amount of loss it would suffer in such an event. The assessing agent may or may not be the auditor selected to perform the audit, although it is reasonable to assume, as a matter of effectiveness and efficiency, that it would be the latter. The FSI cycle is completed when the auditor can issue a clean opinion, as a result of which the FSI carrier becomes contractually obligated to issue the FSI policy.

Under FSI, the auditing firm is not necessarily prohibited from performing consulting services for any insured company. In fact, it could be in the best interest of the FSI carrier to permit the undertaking of consulting since the more the auditor knows about the systems and

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operations of the insured the better the auditor can carry out the audit, thus reducing the FSI carrier's risk.

Two benefits emerge from this scheme. One, it creates an incentive for shareholders to become more active in corporate governance, because whatever coverage amount is chosen the likelihood is that the loss recovery of the current and future shoulders of the company's securities will be limited to the amount of coverage.

Two, the amount of the maximum available coverage and related premium, as well as the amount actually purchased, if any, being a matter of public information becomes a credible signal of the riskiness of the financial statements.

What are the incentives for the participants in the FSI process?

For the insurance carrier, FSI is potentially a very profitable line of business. For the insured, it is a way to signal to the capital markets what its financial statements' risk characteristics are. For the companies that acquire FSI, there should be a concomitant reduction in the cost of capital. For the auditor, it provides a way of offsetting explicit and implicit pressure coming from the client and may limit the auditor's liability.

Lastly, auditors would be perceived as truly independent. For the shareholders, FSI is informative and reassuring, in that the shareholders are receiving important and timely piece of information heretofore not available and recourse to a financially competent warrantor — the FSI carrier.

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