MUSINGS ON POST ENRON REFORMS

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In the aftermath of one of the worst financial and accounting scandals, The SEC and other regulatory bodies have initiated a flurry of reforms designed to improve corporate governance and to hopefully deter future abuses. The Sarbanes Oxley Act of 2002 (SOA) has imposed harsher penalties on errant directors and officers and significantly enhanced the role and responsibility of audit committees and independent directors. But the suggested reforms so far have failed to address the major problem that still besets corporate America today. Namely, the agency costs of managing corporations: CEOs, CFOs and other directors and officers serve their entrenched – insular interest to the detriment of shareholders. In this article, we intend to survey the landscape of the recent suggested reforms, especially as they relate to accounting and audit failures and evaluate their effectiveness in terms of their ability to alleviate the agency cost of conducting business. We will also offer a proposed reform which we believe can be an effective deterrent to financial and auditing failures.

SOA Reforms:

Among the major reforms introduced by the SOA in corporate governance that focus on accounting and auditing issues are those that address specific deficiencies identified by Congress in reviewing the problems at Enron, WorldCom, and others. The following is a sampling of the reforms that the SOA specified:

- Officers are prevented from improperly influencing the auditing process.
- Changing the oversight of auditing firms.
- Entrusting a higher level of financial review to independent audit committees.

A primary instrument for accomplishing these objectives is the establishment of the Public Company Accounting Oversight Board ("PCAOB") with regulatory authority over private audit firms. The PCAOB is empowered by the SOA to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports" for investors in publicly traded securities (SOA § 101(a)). The PCAOB is responsible for registering and inspecting public accounting firms and for establishing or adopting auditing, quality control, ethics, independence, and other standards pertinent to the conduct of audits (SOA § 101(c)).

Faced with an alarming increase in the frequency of restatements – a dramatic jump from approximately eleven restatements per 1000 public companies in 1997 to twenty-seven (Huron Consulting Group, 2002) even with the existing system of peer review, the SOA subjects firms with a record of regularly auditing more than 100 issuers to annual inspection by the PCAOB (SOA § 104(b) (1) (A)). Failure to meet the stipulated standards for the quality control system of the firm can result in the imposition of sanctions by the PCAOB.

Can this additional layer of regulatory oversight accomplish what the SEC, endowed with great authority has failed to do over all these years? There is no reason to expect it would. All regulatory mechanisms impose penalties ex-post, after the wrong-doing is detected. We argue here that ex-post mechanisms, the sine qua non of regulatory enforcement, are nowhere as effective as ex-ante mechanisms – those that typically are implemented by market mechanisms that induce ex-ante incentives for ethical conduct. To elaborate, consider the ways in which regulation functions. Regulatory mechanisms prohibit certain acts while mandating others, where the means of enforcing the prohibitions and the mandated duties are penalties imposed upon discovery that prohibited acts were committed or that mandated actions were not taken. There is rarely, if ever, a reward for doing the right thing. In the SOA case examples of prohibited acts are the barring of some non-audit services (SOA § 201(a)) or the prescription that audit committee members be independent (SOA § 301). An example of mandated duties is the requirement of timely disclosures to the issuer's audit committee of "all alternative treatments . . . that have been discussed with management officials of the issuer . . . ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the [audit] firm."(SOA § 204). How effectively can PCAOB implement these stipulations?

It is doubtful that these lofty regulatory goals can effectively be accomplished. A necessary condition for effective implementation is willingness to enforce the regulations. However, the objectives of the regulators are not necessarily congruent with the interests of the investing public. Regulators' incentives are determined and formulated within a political barter system wherein political favors or threats are exchanged. The incentives generated in such a market are not necessarily aligned with investor interests; they are shaped by interests of groups with interests that likely diverge from those of investors. Witness for example the SEC's backtracking of the requirement that lawyers resign and blow the whistle on securities law violations (influenced by the lawyers' lobby) and of the barring of tax shelter planning by auditors (effected by the accountants' lobby)

Moreover, with the exception of those with a high measure of integrity – a rare commodity in these days – regulators seek entrenchment in bureaucratic power and the preservation of the ability to exchange political favors so as to facilitate post-regulatory career marketability. This quest requires the goodwill and the cooperation of interest groups with goals that are not aligned with those of investors.

Further, enforcement is costly and requires budget authorization. But the availability of the requisite budgets depends on political priorities that may lie outside of the domain of corporate governance reforms. Competing demands for budgets can arise unexpectedly, such as when wars are imminent, or tax cuts. Also, political agendas can shift over time and, in periods of complacency, corporate governance reforms may be accorded low priority so that the SOA regulations would not be consistently enforced over time.

Consider also the ex-ante incentives of the would-be wrong-doers. Regulatory penalties are effective only if agents expect their misdeeds to be detected. If the probability of detection is perceived to be small, the errant would not be deterred. Rational wrong-doers would reasonably expect regulatory hesitancy and backtracking and hence are quite likely to perceive a small probability of detecting their transgressions. And suppose that to offset small probabilities of detection draconian penalties are imposed when the wrong-doing is discovered. Can corporations then staff their boards of directors and audit committees with able members who might face such heightened risks?

Even if ultimately detected and penalized, the rendering of justice typically will come too late to properly rectify the wrongs, compensate investors for their losses, or restore their confidence. Punishments that loom in the distance horizon cannot function as effective ex-ante deterrents.

Beyond all these impediments, there is the question of feasibility. Are the SOA dicta workable in principle? Consider for example the requirement that audit committee members be independent (SOA § 301). Can they be?

The Myth of Independence:

Independence is an unobservable state of mind. While independence may be legislated as in SOA, it cannot be easily made to happen. Even a cursory analysis of directors' (including audit committee members) incentives and motivations suggests that they are themselves subject to an agency problem, not significantly different from that perverting the relation between managers and shareholders: directors and audit committee members wish to be re-appointed to their board positions. Meyers and Partners (2002) report average director compensation in the 200 largest US corporations in 2001 of $152,626. Good relations with the CEO and his team also bestow valuable benefits on directors and audit committee members beyond the immediate monetary rewards, including but not restricted to social connections, prestige, likelihood of becoming a member in other companies' boards, etc.

The SEC has recently proposed rules that would create a requirement for companies subject to the Commission proxy rules, including registered investment companies, to include in their proxy materials the names and certain other information regarding security holder nominees for election as director under certain specified conditions (SEC, October 8, 2003). However this will hardly remedy matters. Board elections are by slate and dissidents face substantial impediments when they attempt to put forward a competing slate (Bebchuk and Kahan, 1990). Hence, the management-proposed slate of directors is the one that typically ends up being offered. As a result of all this, the CEO and his team dominate the nominating process, and directors feel compelled to acquiesce to the CEO's compensation structure as long as the latter is reasonably defensible.

1. Also militating against a genuine independence of directors and audit committee members is the directors' pay structure. As mentioned above, if well paid, the directors would have little incentive, if any, to oppose the CEO's pay and/or his other policies, i.e. there would be *de facto* dependence on management. Alternatively, if not well paid, the directors would have little interest, if any, in

> bringing an independent perspective to bear on real policy issues or managerial pay: they are not paid enough to make it worth their effort and risking tense relations with the management they need to work with. Moreover, directors typically have only nominal equity interests in the company (Baker, Jensen, and Murphy, 1988, and Core, Holthausen, and Larcker, 1999). But even if directors owned a significant share of the equity as long as they are not restricted from disposing of the equity interest, they would still have incentives to overlook attempts by the management to inflate earnings or other accounting measures – this will only help them in selling their stock at higher prices! Now suppose directors hold restricted stock with lock provisions that bars them from selling it before a certain date. This may create the perverse incentive for the directors to encourage (and certainly not discourage) management in "cooking the books" so as to inflate the price immediately prior to the expiration of the lock-up provisions on the sale of their held shares. Randomizing the date at which the lock-up provisions expire would only exacerbate matters: incentives to inflate the stock price would operate with unabated strength until such time that the lock-up provisions expire at a random date.

This discussion points to a serious dilemma confronting any social planner who seeks to initiate corporate governance reform. Namely, even if reforms were successful in endowing shareholders with real power and ability to affect corporate decision, attempts to adumbrate financial disclosures – to shade them so as to bias inferences toward believing the company's prospects are rosier than they truly are – might persist.

Inevitably, some shareholders, possibly with increasing number and intensity since the beginning of the Internet boom, are guided by a short horizon orientation when deciding on buying, holding, or selling stock. They are the day-traders, the speculators whose interest is mainly to buy cheap and sell dear, and thus exit the corporation as early as they can make a profit. If these shareholders hold sway over the corporation's executives and directors, it would be in their interest to induce the kind of accounting obfuscation and deceit that we have witnessed during the last two years (Ronen and Yaari, 2002). A reformer is thus hampered by the inability to distinguish, ex-ante, between these short-horizon shareholders and those with the longer horizon – who would be interested in maximizing the long-term, fundamental value of the company and not merely to inflate prices for short-term gains; the latter would not be interested in misleading presentations or murky financial statements such as Enron's. In other words, empowering shareholders in not a panacea: one must know which shareholders to empower!

The Executive Option Debate:

Setting aside the shareholder horizon conundrum, and assuming empowered shareholders and their (hopefully independent-minded) representatives on the Board and Audit Committees have the fundamental value enhancement as their primary objective, how can they induce management to simultaneously invest effort and entrepreneurial zeal to augment the company's value and refrain from "cooking the books"? One of the most debated topics these days is executive options. While options may in the best of circumstances incentivize management to perform, they also induce them, because of the potentially immense gain they confer in a rising market, to inflate earnings and other wise distort financial presentations.

Legislators and others have been recently voicing strong support for reporting options granted to executives as expenses, decreasing the income numbers. The lower income numbers, expensing enthusiasts claim, will better reflect the reality of the higher compensation paid to executives in the form of options. This is only partially true. The diluted earnings per share number that is predicated on the hypothetical exercise of options accomplishes much of this goal. But more importantly, it will fail to lessen inherent incentives of the less ethically endowed executives to "manage" earnings, and in extremis, to "cook the books". The reason is straightforward. Suppose it is ruled that all companies should expense executive options. Also, assume (unrealistically) the market had not already reckoned the diluting impact of the options granted on shareholder's wealth by perusing the ample disclosures in the financial statements; we would witness an immediate price decline reflecting the anticipated future stream of expenses to be reported when future options will be granted. Once the market price has adjusted to impound the impact of the rule, the earnings "management" game would proceed unabated: executives would still strive to meet or beat consensus analysts' forecasts (which now would be dampened to reflect the anticipated option expense) so as to cause the stock price and the value of their options to increase. The incentive to use the cornucopia of accounting tools at their disposal to increase earnings would not be blunted.

The malaise lies not in how options granted are accounted for, but in the granting itself. In a July 21, 2002 New York Times op-ed article, Senator Lieberman credits the granting of options with attracting talent and spreading wealth. But if a large compensation is necessary for attracting talent, other forms of payment can be considered -- cash comes to mind. So, if the average compensation required to attract a bright executive is $50 million, a package of incentives guaranteeing this amount on the average can be structured without options. But the package hopefully will help eschew the perverse incentives options create for the "management" of earnings. Here is one possibility.

The executive's compensation would consist of a salary and a bonus based on the ratio of earnings to equity. The executive would earn a bonus if this ratio exceeds the industry's comparably computed ratio and would incur a properly constructed penalty if it falls short of the industry-wide ratio. The twist, however, is that the ratio on the basis of which he would be compensated is not the periodic earnings/equity ratio but the ratio of cumulative earnings to equity (where the accumulation starts from the beginning of the executive's tenure). Suppose in the first year of his tenure, the executive was able to report a ratio that is higher than the industry's and thus earn the bonus; he would have to disgorge that and in addition pay a predetermined penalty if the ratio at some future period during his tenure falls short of the industry's ratio. The additional twist is that the process of settling up will continue through a number of years (say three or five) after the executive steps down from his position.

Here are the benefits. The incentives to “manage earnings” by borrowing earnings from future income will be all but eliminated. The extra buck made today with inflated earnings, plus a penalty, will be disgorged in the future. Beating analysts’ consensus forecasts would no longer be the bonanza it currently is: if the earnings are not real – if borrowed from the future – penalties will ensue. Also, by deferring the final settling-up to some years after retirement, any earnings “inflation” in the last years of the executive’s tenure would be deterred. And, at the same time, by linking the bonus to the degree to which the company’s ratio exceeds the industry’s ratio, the motivational impulse to perform and excel would be preserved.

This may be a promising way to disentangle the need to motivate managers to perform from the perverse incentives to “cook the books” that options engender. But it would not constitute equilibrium under the present institutional setting. As mentioned, directors, who by their position in the company and the dependence they have on the CEO and his team for their pay and perks, would not embrace this solution if the CEO resists it; and resist it the CEO may, simply because it would limit his control of the ability to “engineer” price inflation, and profit. Nor would short-horizon shareholders be enthused with the loss by managers of their penchant for earnings inflation.

Having pointed out the immense difficulties associated with reforming the conduct of directors, audit committee members, and managers, we turn now to a promising alternative arena, that of the gatekeepers, especially the auditors.

The Role of Auditors:

One of the causes suggested as contributing to the current state of financial disarray is the failure of the auditing profession to fulfill its role as independent gatekeepers. Currently, the incentives driving auditors' behavior may not elicit unbiased reports. Auditors are paid by the companies they audit and thus depend on CEOs and CFOs, who effectively decide on their employment and compensation. This creates an inherent conflict of interest.

Can auditors be Independent?

The perception of the auditor's conflict of interest (lack of independence) started with a host of high profile, highly publicized corporate failures and near failures, the Enrons, Worldcoms etc. Among the (probably false) premises for the culpability of the auditor was the belief that the problem could have been avoided had not the auditing firm also provided lucrative consulting services to the audit client: had auditors not been enticed by the lure of large fees, they would have done the right thing. Unfortunately, the prohibition against an auditor providing consulting services ends up with the auditor acquiring less knowledge of the client's systems and operations even when, because of the great changes in record keeping technology and the increase in the sophistication of the client's operations, more knowledge is critical. In fact, an indefinite stream of future audit fees to be received for being continually engaged as auditor supplies all the necessary incentives for complying with management’s wishes, or, at the very least, the grounds for being perceived as dependent on management. This conflict of interest has been intensified by changes in the business and audit environment that have occurred over the few last decades.

To see why this happened we need to consider the audit process. It comprises two components: the validation of data (GAAS) and the validation of measures of financial statement items (GAAP). The first is designed to verify the appropriateness, completeness, accuracy and timelines of the accounting data. The second involves the reasonableness of the values presented in the financial statements, e.g., the quantification of inventory at cost or market whichever is lower, or the net realizable values of accounts receivables after write-offs and allowances for uncollectible debts.

While the recent spate of "audit failures" is not unusual when viewed over, let us say, the last fifty years -- in this period "audit failures" happened all the time – the failures become more noticeable in a weak economy and in an environment of stock price declines and where the current failures were so visibly enormous. Indeed, the visibility, frequency and magnitude of "audit failures" have increased substantially over the last few decades. Reasons for this possibly include in addition to the magnitude of the failures, a more aggressive plaintiff’s bar coupled with increased demands on the auditor in light of more sophisticated and complex business contracts and transactions. Also noteworthy is the fact that an overwhelming number of visible audit failures were associated with the largest and best audit firms. What are the likely causes of this astonishing observation?

One likely explanation lies in the movement from an industrial economy to an information economy. In the industrial economy of fifty years ago the primary focus of the auditor was the validation of data, through extensive counting of inventory and confirming accounts receivables and payables with external parties. In addition, other than long term assets, e.g., plant and equipment and long term debt such as bonds, the rest of the balance sheet had, by the time the auditor had completed his/her field work, by and large, completed its cycle, e.g., most of the inventory turned over, most of the receivables were collected, and most of the payables were settled. Auditors could look back and further validate his/her assessment of the data and valuations as of the statement date.

At least two major changes have had a significant impact on the auditor: the computer and the change in the nature of assets and liabilities. But while the computer has substantially expanded the amount and quality of data available, the auditor became dependent on the data processing systems.

The movement from tangible to intangible assets with very long lives and from liabilities whose principal and terms are known and specified to liabilities whose principal and terms are legally related to and dependent on other factors such as found in derivatives has substantially reduced the auditor's ability to validate the values presented in the financial statements. Current financial statements are a blend of largely verifiable, but uninformative, depictions of past transactions and largely unverifiable, but possibly informative, projections of future outcomes. Under existing GAAP, many of those projections show up in the balance sheets as assets, and even as revenues. Consider the Interest Only Strip, shown as an asset in the balance sheets of specialty finance companies under Financial Accounting Standard 140. This asset is simply the present value of a future stream of unrealized income, recorded as current income. Its valuation is highly subjective and acutely sensitive to changes in assumptions. It is extremely difficult, even for a well-intentioned auditor, to dispute and reject the projection of a manager wishing to improve the appearance of his financial statements. Or consider Rebecca Smith's report (Wall Street Journal; January, 17, 2002) on Enron's Braveheart venture (incorporated on December 28, 2000): "Enron assigned the partnership a value of $124.8 million based on its projections of the revenue and earnings potential of the Blockbuster Venture, according to company documents." Such largely unverifiable intangibles make financial statements difficult to audit[1]. They constitute private information that cannot be perfectly verified ex post. We can only observe whether a manager's forecasts were accurate; we cannot know that he did not truly believe that the forecasts were accurate when made. Under these circumstances, in equilibrium, and on average, managers' presentations will not be truthful (Ronen and Yaari, 2002). Even detailed standards have not prevented unverifiable intangibles from creeping into the financial statements.

This changed environment puts the auditor in a very difficult position, especially within the extremely competitive market for audit services. The combination of data overload,

[1] We do encounter sweeping admonitions in the press to the effect that accountants should make sure that "… the overall impression created by GAAP fairly portrays the underlying economics" (Michael Young's statement in Steve Liesman's "SEC Accounting Cop's Warning: " Wall Street Journal, February 12, 2002). Easier said than done!

the black box syndrome, and valuation uncertainty coupled with price competition puts the auditor in the position of being at the mercy of the client. In an uncertain environment marked by the difficulty of verifying valuations that are necessarily soft and subjective, the auditor who is paid by the potentially prevaricating client, is naturally tempted to adopt the client's position. Thus, while some audit failures were precipitated by incompetence and corruption, the conditions that created audit uncertainty likely contributed to the audit failures brought about by auditor malfeasance.

A major flaw, one that has persisted over time, is that the auditor is effectively retained by the management of the client in the case of public companies, creating a circumstance wherein the auditor is beholden to the client and its management. Theoretically, auditors are supposed to be the agents of the shareholders. But in practice, it is management that engages the auditor and ultimately pays for his services and hence determines auditing and consulting fee structures to elicit actions, including opinions and assurances that it desires from the auditor. The risk of losing fees from a long-term audit engagement - even without the limitations on non-audit services imposed by the Sarbanes-Oxley Act of 2002 - effectively guarantees that the auditor complies with management's wishes.

The anticipation of potential gains from acquiescing to management's wishes more than offsets the threat of legal liability against auditors from shareholder class action suits. Furthermore, a large proportion of shareholder recoveries in audit failure-related class action suits are made out of the corporation's own resources. Ironically, such recoveries diminish the wealth of shareholders who purchased the shares at prices potentially inflated as a result of misrepresentations even further due to deadweight losses arising from the cost of defending the suit. It is tempting to suggest that an increase in the liability exposure of the auditors can deter malpractice but it falls short on two grounds. One, it fails to address the misallocation of risk and resources. Imposing higher litigation penalties on the auditor ex post does not enhance the ability of society to distinguish, ex ante, between firms with intrinsically high returns from the Enrons and Worldcoms of the world that have intrinsically low or negative returns but misrepresent themselves as high-return firms. Two, increasing exposure to liability and instituting high-legislated penalties may drive auditors out of the business of auditing altogether. Again not a welcome prospect.

Financial Statement Insurance: A Market Solution

Is there a potential cure for the auditor's "conflict of interest"? Unfortunately, Prosecution and punishment may not adequately deter wrongdoing, as intentional misrepresentation is difficult to discover or prove. Overhauling the regulatory structure and adding layers of supervision and monitoring by the government would be inefficient and socially wasteful and little can be done in the short run to cultivate ethical personalities. Rather, we believe that the solution lies in market mechanisms that eliminate the conflict of interest auditors face and properly align their incentives with those of shareholders.

The solution proposed is a financial statement insurance mechanism: Instead of appointing and paying auditors, companies would purchase financial statement insurance that provides coverage to investors against losses suffered as result of misrepresentation in financial reports. The insurance coverage that the companies are able to obtain is publicized, along with the premiums paid for the coverage. The insurance carriers then appoint and pay the auditors who attest to the accuracy of the financial statements of the prospective insurance clients. Those announcing higher limits of coverage and smaller premiums will distinguish themselves in the eyes of the investors as the companies with higher quality financial statements. In contrast, those with smaller or no coverage or higher premiums will reveal themselves as those with lower quality financial statements. Every company will be eager to get higher coverage and pay smaller premiums lest it be identified as the latter. A sort of Gresham's law in reverse would be set in operation, resulting in a flight to quality.

The inherent conflict of interest facing the auditor is thus removed by severing the agency relation between the company's management and the auditor. In the context of a free market mechanism, insurance carriers would serve the role of principal rather than the client's management. The critical features of the FSI scheme underlying this study are: (i) the shifting of the decision on auditor employment from the client-management to the insurer; and (ii) the effect of publicizing the premium charged.

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As part of FSI, the insurance carrier would retain and pay the auditor. It is contemplated that FSI providers would have a list of approved auditors from which a company can select an auditor. Nevertheless, it is expected that the auditor would owe his/her duty and loyalty to the FSI carrier for at least two reasons. Firstly, obviously it is the FSI carrier that is paying the auditor and therefore it focuses the auditor efforts towards the protection of the FSI carrier. Secondly, it is reasonable to assume that any given auditor would be providing audit services to more than one of the FSI carrier's insureds thereby 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 Appendix (containing material taken from Ronen (2002))[2] provides a more detailed description of the proposed FSI process with graphs showing the sequence of the steps required in the implementation as well as the inter-relationships among the various parties participating in the insurance mechanism and the roles they play

In the FSI world the auditing firm is not necessarily prohibited from performing consulting services for any insured; it is a matter of seeking permission from the FSI carrier. It could be argued that it is in the best interest of the FSI carrier to permit the undertaking of consulting since the more the auditor knows about the systems and operations of the insured the better the auditor can carry out the audit; it could be seen as a way of reducing the FSI carrier's risk.

If FSI becomes pervasive in both the public and private company sectors, it could be anticipated that given the FSI carriers' vetting of auditors and the remuneration of the auditor by the FSI carriers, whose objective is to minimize the amount of claims made against it for "audit failures", the pool of qualified and respected auditors would grow because auditors would deem it in their own interest to move towards professional

[2] Ronen Joshua, Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited, Stanford Journal of Law, Business and Finance, vol. 8:1, 2002: 1-30.

excellence in an effort to garner more audit assignments thereby creating a competition for excellence in the CPA profession.

FSI does not guarantee that investors would recoup all of their losses in the event of financial statements misrepresentation. The point is that under the FSI mechanism, shareholders' losses are apt to be less because of better audit quality and the incentives companies have to improve the quality of their financial statements so as to decrease their cost of capital.

Auditor Conservatism

It is tempting to suggest that the FSI scheme might induce an excessive, and harmful, degree of auditor conservatism. This need not be the case. We should point out that class action security litigation can involve sellers who suffer losses resulting from overly conservative statements as well as the typical purchasers' class. The fact that these were fewer in the past merely reflects the fact that companies' incentives are skewed in the direction of inflating, rather than deflating, earnings. The FSI scheme would tend to balance the incentives and induce less bias and greater accuracy in financial statements. If, for example, FSI induces ultra-conservatism, the incidence of sellers' losses will be expected to increase, prompting a higher insurers' expectation of sellers' claims, in turn inducing them to guide the auditors they hire toward emphasis on greater accuracy. Removing the conflict of interest through the FSI scheme will minimize the potentially adverse effects given rise to by the subjectivity that inheres in accounting decisions.

Some Implementation Issues:

Undoubtedly, the implementation of FSI has the potential of changing the dynamics of how the different parties to this game relate to each other in the context of a possibly changing legal environment. The social and political effects of the proposed insurance mechanism extend beyond the boundaries of the accounting profession. Consider, for example, the effects of the legal liability of the auditors. Serving as agents of the insurance carriers, they would-be contractually obligated to their principal -- the insurance carrier -- and not to their traditional clients. The consequences they may face as a result of the shift in the locus of who they owe their loyalty to are significant. Instead of penalties they face under the existing regime -- threats of non-renewal of engagement if they displease their clients (by not acquiescing to offering clean opinions on misleading statements) and/or recoveries by misled investors -- they face under FSI the more incentive compatible threats of being dropped by the carrier from lucrative engagements if they do not exert optimal effort. At the same time, they would be less likely to face liability suits initiated by investors: plaintiff attorneys would perceive the difficultly of winning the case against auditors who, given the FSI arrangement, cannot be shown to have had the incentive to cooperate with a management intending to mislead. Similarly, directors and officers of clients which face fewer investors suits after having been subjected to vigorous underwriting reviews and more effective audits and now that they can claim they had the incentives to effect high-quality financial statements so as to reduce their cost of capital. In turn, one would expect the plaintiff's bar to lobby against FSI since they would fear the loss of lucrative fees they now earn from successfully bringing class action suits against directors and officers and auditors.

A looming problem is a possible insurers' reluctance to issue financial statement insurance policies at very high coverage amounts lest they lack the capacity to pay. But recall that coverage under the proposed régime need not exceed the level investors recover under the current régime. This means that, in equilibrium, the premiums paid under the proposed regime would at most equal the total cost to corporations of directors' and officers' insurance, audit fees, and the additional litigation settlement costs they incur as a result of class-action suits filed against them. Under this condition, the coverage would be affordable—it is the same as under the current regime. But suppose that the coverage extended under the proposed regime would exceed the insurance coverage under the current regime. Will the insurance industry have the capacity to pay? The answer yes because, unlike property and casualty insurance for example, the losses insured against—decreases in the valuation of companies resulting from omissions or misrepresentations in the financial statements—can be hedged in the capital markets with properly constructed derivatives, the exercise of which can be made contingent on the financial statement and audit failures that are manifested in omissions or misrepresentations. Specifically, the insurer can buy a special put option with a duration that corresponds to the period covered under the policy. The put would be exercisable upon a stock price decline of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements. Investment funds (pension funds, mutual funds, and the like) would be willing to sell these puts for less than the price of general puts (that are not conditional on misrepresentations) and would thus enable the insurer to reinsure whichever portion of the coverage he wishes not to retain at an affordable cost. The put sellers can minimize their exposure on these written puts by constructing portfolios that are well diversified with respect to the risk of misrepresentations and omissions. The assessment of such risks can be provided by independent rating organizations akin to bond rating agencies, such as Standard & Poor's Corp.

Conclusion

Several causes have been advanced in the media for precipitating an accounting melt-down: irrational exuberance, infectious greed, the stock market bubble, moral turpitude of executives, unethical accountants, non-audit services, and related ills. But reforming boards of directors, audit committees, and top managements of corporations is very difficult at best. The inherent conflicts of interest in the auditor-client relationship combined with the unobservability of financial statements quality, together, are likely culprits, however, and are more amenable to reform. Bubbles and exuberance merely magnify the payoffs so that executives are more tempted to "cook the books" and the auditors' conflict of interest is aggravated.

Financial Statement Insurance provides a market- based solution that acts as an effective check on the issuance of overly-biased financial statements. First, by transferring the auditor hiring decision to the insurer, this scheme eliminates the auditors' inherent conflict of interest. Second, the publicization of the insurance coverage and the premium will credibly signal the quality of the insured's financial statements and direct investments towards better projects. At the same time, the ability to signal the quality of financial statements will provide companies with incentives to improve the quality of their financial statements. Thus, along with the consequent improvement in audit quality, FSI will result in fewer misrepresentations, and accordingly, in fewer suits and shareholders' losses.

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APPENDIX

THE FSI PROCESS

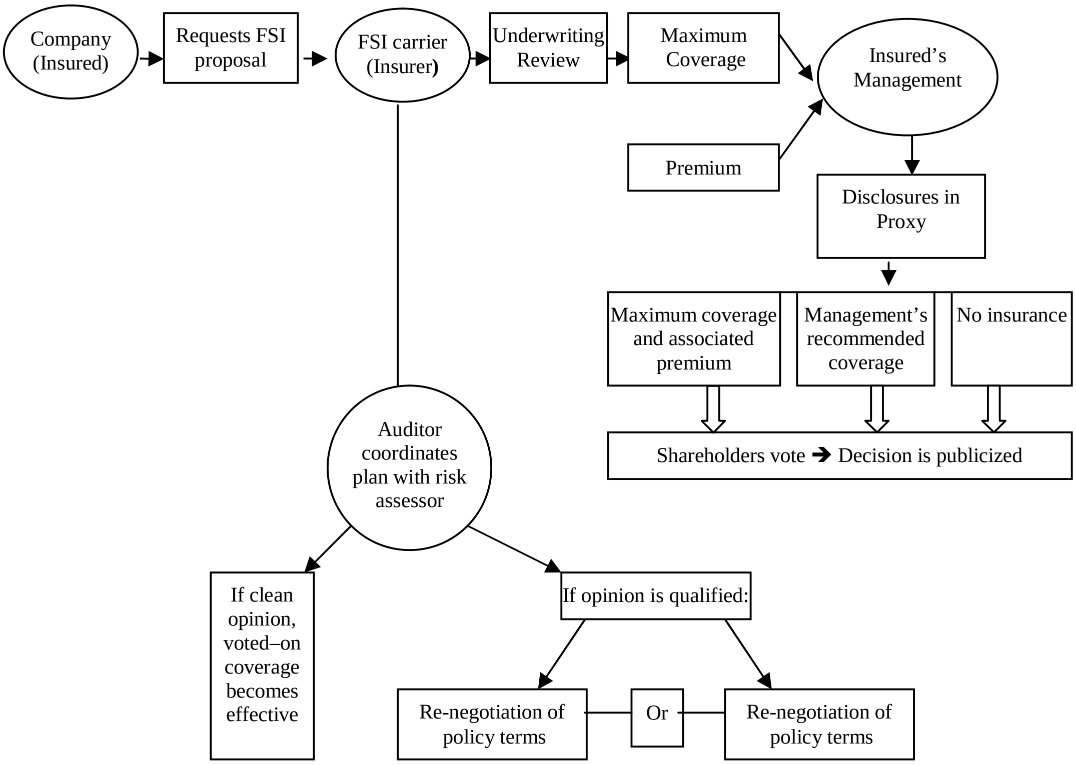
1. The FSI Procedure

The FSI underwriting procedure starts with a review of the potential insured. The review is performed, on behalf of the FSI carrier, by an expert risk assessor, who investigates the nature of conditions such as the following:

- ♦ The nature, stability, degree of competition, and general economic health of the industries in which the potential insured operates.
- ♦ The reputation, integrity, operating philosophy, financial state, and prior operating results of the potential insured's management.
- ♦ The nature, age, size, and operating structure of the potential insured.
- ♦ The potential insured's control environment and significant management and accounting policies, practices, and methods.

The FSI process might proceed as follows (see Figure 1):

Figure 1
The FSI Process



Step 1—The potential insured requests an insurance proposal from the FSI carrier. The proposal contains, at a minimum, the maximum amount of insurance being offered and the related premium. Typically, it also specifies a schedule of amounts of coverage below the maximum along with associated premiums. The proposal request is made prior to the preparation of the potential insured's shareholders' proxy on the basis of the underwriting review described above. The reviewer can be the same auditor who will eventually audit the financial statements.

Step 2—The proxy offers the following alternatives:

- The maximum amount of insurance and related premium as offered in the insurance proposal.
- The amount of insurance and related premium recommended by management.
- No insurance

Step 3—If either of the insurance options set forth in Step 2 is approved, then the reviewer and the auditor cooperatively plan the scope and depth of the audit to be conducted.

Step 4—If, after the audit, the auditor is in the position of rendering a clean opinion, the policy is issued. That is, the originally proposed coverage and premium will be binding on the insurance carrier if the auditor's opinion turns out to be clean. If the auditor's opinion is qualified the insurer will not provide any coverage unless the company can then renegotiate different terms with the insurer, which would depend on the auditor's findings and reasons for qualification. To the extent the policy terms are renegotiated, the new agreed-upon terms would be publicized.

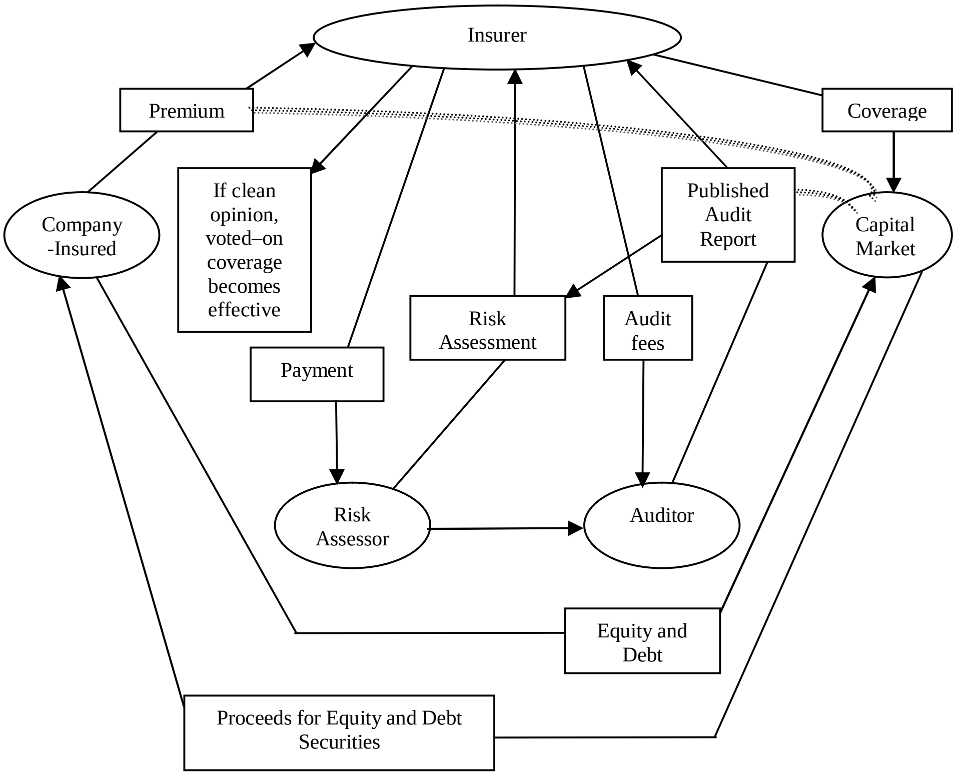
Step 5—The auditor's opinion will contain a paragraph disclosing the amount of insurance that covers the accompanying financial statements and the associated premium.

The FSI concept also contemplates an expeditious claims settlement process.

The FSI carrier and the potential insured cooperatively select a fiduciary organization whose responsibility is to represent the financial statement users when a claim is made. Part of the fiduciary's responsibility is the assessment of claims before notifying the FSI carrier.

After the fiduciary notifies the FSI carrier of a claim, the FSI carrier and fiduciary mutually select an independent expert to render a report as to whether there was an omission or misrepresentation and whether it did give rise to the amount of losses that resulted. Within a short time after receiving the expert's report, the FSI carrier compensates the fiduciary up to the face amount of the policy for the damages.

Figure 2
Relationships Among the Parties



Legend
Solid lines indicate actual flows
Fuzzy lines indicate information flows