

just sitting there and waiting for the
 appeal, often resulting in messy, long
 drawn out cases costing the litigants
 precious time and money.

In arbitration, one can be
 guaranteed a fair hearing to the extent
 the arbitration panel will be made up
 of a team of experts who are familiar
 and understand the intricacies of the

and, in many cases, the industry. In
 addition, the arbitration process is
 typically faster and less expensive
 than litigation. The arbitration
 process is also more flexible, allowing
 the parties to tailor the process to their
 needs.

Arbitration is a viable alternative
 to litigation for many types of
 disputes. It offers a faster, more
 cost-effective and more flexible
 means of resolving disputes. The
 arbitration process is also more
 confidential than litigation.

Arbitration is a viable alternative
 to litigation for many types of
 disputes. It offers a faster, more
 cost-effective and more flexible
 means of resolving disputes. The
 arbitration process is also more
 confidential than litigation.

The audit environment puts the auditor in the position of being at the mercy of the client. The auditor, who is paid by the client, is naturally tempted to adopt the client's position. This is a phenomenon akin to a "Stockholm Syndrome", wherein the captive identifies with his or her captor. One major flaw that has persisted over time, is that the auditor is retained by the client, which, ipso facto, means the management of the client in the case of public companies, and therefore creates a circumstance wherein the auditor is beholden to the client and its management. Conventional wisdom sees nothing wrong with this situation. As a result, the auditor ends up seeing things through the eyes of management and may even believe he/she is doing the right thing.

My solution is financial statement insurance (FSI). FSI significantly changes 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 coverage, financial compensation for misrepresentations 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 his/her duty and loyalty to the FSI carrier for at least two reasons. First, obviously it is the FSI carrier paying the auditor and therefore it focuses the auditor's efforts towards the protection of the FSI carrier. Second, it is reasonable to assume any given auditor would be providing audit services to more than one of the FSI carrier's insured clients creating a situation whereby a costly audit failure would jeopardise 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 FSI carrier to secure a proposal for 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.

As part of the proposal process, the FSI carrier would send its agent to the potential insured to assess the risk of misrepresentations in financial statements and the amount of loss it would suffer in the event of such misrepresentations. 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, it would be the auditor performing the assessment. The FSI cycle is completed when the auditor is in the position of issuing a clean opinion, as a result of which the FSI carrier becomes contractually obligated to issue the FSI policy.

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 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.

In the case of the public company it is envisioned the company, in its proxy statement, would provide the

audit assignments. The FSI cycle begins with a company approaching a FSI carrier to secure a proposal for 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.

As part of the proposal process, the FSI carrier would send its agent to the potential insured to assess the risk of misrepresentations in financial statements and the amount of loss it would suffer in the event of such misrepresentations. 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, it would be the auditor performing the assessment. The FSI cycle is completed when the auditor is in the position of issuing a clean opinion, as a result of which the FSI carrier becomes contractually obligated to issue the FSI policy.

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 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.

In the case of the public company it is envisioned the company, in its proxy statement, would provide the

Restructuring the auditing market

BY JOSHUA RONEN

At the heels of the accounting scandals of Enron and its likes, the diagnosis of what was ailing the auditing profession – lack of independence – has brought about the largely ineffective remedies prescribed by the Sarbanes-Oxley Act of 2002. In what follows I propose a solution that bolsters the auditor's independence, upholds the auditing profession's integrity, and most importantly, improves the quality and content of the audited financials.

The audit environment puts the auditor in the position of being at the mercy of the client. The auditor, who is paid by the client, is naturally tempted to adopt the client's position. This is a phenomenon akin to a "Stockholm Syndrome", wherein the captive identifies with his or her captor. One major flaw that has persisted over time, is that the auditor is retained by the client, which, ipso facto, means the management of the client in the case of public companies, and therefore creates a circumstance wherein the auditor is beholden to the client and its management. Conventional wisdom sees nothing wrong with this situation. As a result, the auditor ends up seeing things through the eyes of management and may even believe he/she is doing the right thing.

My solution is financial statement insurance (FSI). FSI significantly changes 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 coverage, financial compensation for misrepresentations 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 his/her duty and loyalty to the FSI carrier for at least two reasons. First, obviously it is the FSI carrier paying the auditor and therefore it focuses the auditor's efforts towards the protection of the FSI carrier. Second, it is reasonable to assume any given auditor would be providing audit services to more than one of the FSI carrier's insured clients creating a situation whereby a costly audit failure would jeopardise 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 FSI carrier to secure a proposal for 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.

As part of the proposal process, the FSI carrier would send its agent to the potential insured to assess the risk of misrepresentations in financial statements and the amount of loss it would suffer in the event of such misrepresentations. 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, it would be the auditor performing the assessment. The FSI cycle is completed when the auditor is in the position of issuing a clean opinion, as a result of which the FSI carrier becomes contractually obligated to issue the FSI policy.

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 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.

In the case of the public company it is envisioned the company, in its proxy statement, would provide the

For the auditor it provides a way of offsetting the explicit and implicit pressure coming from the client and may limit the auditor's liability

shareholder with three options to vote on (1) the maximum amount of coverage and the related premium, (2) an amount of coverage different from the maximum being recommended by management and the related premium, and (3) no insurance.

Two benefits emerge from this scheme. One, it creates an incentive for shareholders to become more active in corporate governance, because whatever amount is chosen, the likelihood is that the loss recovery of current and future holders 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, on a very timely basis, of the riskiness of the financial statements.

Buying into the programme

What are the incentives for the participants in the FSI process? For the insurance carrier it is simple, FSI is a new and potentially very profitable line of business. For the insured it is straightforward, 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 the explicit and implicit pressure coming from the client and may limit the auditor's liability.



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

Joshua Ronen is a professor of accounting at New York University's Stern School of Business

WHO INVITES SOMEONE FOR DINNER DURING A FAMINE?

Someone Just Like You

Help Us, Help!

MEDECINS SANS FRONTIERES
無國界醫生

Tel: (852) 2338 8277
Fax: (852) 2304 6081
International website: www.msf.org
Hong Kong website: www.msf.org.hk

MORE THAN 60,000 PEOPLE DIED IN SOUTH SUDAN DURING THE 1998 FAMINE. MSF RAN NUTRITIONAL PROGRAMMES AND TREATED OVER 22,000 SEVERELY MALNOURISHED CHILDREN. EVERYDAY, MSF VOLUNTEERS ARE WORKING TO SAVE LIVES IN DESPERATE SITUATIONS AROUND THE WORLD. HELP US HELP.