Financial statements insurance enhances corporate governance in a Sarbanes–Oxley environment

Julius Cherny and Joshua Ronen*
Received: 5th March, 2004

*Stern School of Business of New York, Henry Kaufman Management Center, 44 West Fourth Street, New York, NY 10012, USA
Tel: +1 212 998 4144; Fax: +1 212 995 4599; E-mail: jronen@stern.nyu.edu

Julius Cherny *is an assistant professor of accounting at Baruch College of the City University of New York.*

Joshua Ronen *is a professor of accounting at the Stern School of Business of New York University.*

ABSTRACT

KEYWORDS: financial statements insurance, Sarbanes–Oxley Act, corporate governance accounting systems

The Sarbanes–Oxley Act has sought to reform the existing corporate governance mechanisms in order to alter the circumstances that led to the accounting debacles at Enron, WorldCom and so on. But other than adding and injecting additional regulatory layers, the Act stops short of providing a workable operating definition of corporate governance and does not effectively deal with the perverse incentives that have generated the 'urge' to 'cook the books'. This paper claims that at the very core of proper corporate governance is the communication of information that managers of corporations possess to outside investors. It is important that this communication be both relevant and truthful. This paper describes a mechanism that is designed to remedy corporate governance failures by realigning incentives of outside auditors with those of the shareholders. This is accomplished by insuring financial statements against losses incurred by shareholders that are caused by omissions or misrepresentations.

International Journal of Disclosure and Governance, Vol. 1, No. 3, 2004, pp. 226–237
© Henry Stewart Publications,
1746–6539

INTRODUCTION

The recent crop of high-profile corporate failures and their related 'audit failures' have produced two interrelated consequences: The Sarbanes–Oxley Act 2002 (the Act)[1] and an ever-growing literature offering guidance as to what is appropriate and acceptable 'corporate governance' (CgLit). In the following the authors argue that the Act does not offer an efficient remedy for corporate governance failures. They suggest, instead, a market mechanism in the form of financial statements insurance (FSI) that directly addresses 'audit failures' and indirectly mitigates corporate governance hazards. Beyond the mitigation of the corporate governance hazards, FSI achieves *de facto* what the Act problematically and expensively sets out to do by legislation, that is, an improvement in corporate governance and its corollary, reliable and relevant financial information communicated to interested external parties such as shareholders, creditors, etc. FSI accomplishes the desired result through a realignment of incentives, whereas the Act hopes to reach its intended goal through threat and punishment.

The Act sets out 'To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.' It is

reasonable to claim that the Act's approach to solving what its authors deemed to be a crisis in corporate governance is essentially structural in nature. The three major areas that were addressed by the Act that are of interest in the present instance are the establishment of the Public Company Accounting Oversight Board (PCAOB), auditor independence and corporate responsibility.

The Act seeks to address the problem it set out to solve by increased regulation and penalties, empowerment of audit committees and the reduction of the auditor's involvement with the client. The Act does not unravel the Gordian knot of the auditor/management nexus, the ground zero of the problem: without an alteration in the auditor's incentives and the establishment of a corporate governance framework it is reasonable to believe that matters will return to the *status quo ante*. It is in the nature of humans that they will find workarounds for impediments and enthusiasm for matters that further their interests.

THE ACT

The Act charges the PCAOB with the responsibility 'to protect the interests of investors and further the public interest in the preparation of informative and independent audit reports for companies the securities of which are sold to, and held by and for, public investors' (section 101 (a)).

The Act spells out the duties of the PCAOB as follows:

- Section 102: Register public accounting firms that prepare audit reports for issuers.
- Section 103: Establish or adopt, or both, by rule, auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for issuers.
- Section 104: Conduct inspections of registered public accounting firms.
- Section 105: Conduct investigations and disciplinary proceedings concerning, and impose appropriate sanctions where justified upon registered public accounting firms and associated persons of such firms.

From the above it would appear that the PCAOB has been substantially delegated the Securities and Exchange Commission's (SEC's) rule promulgation and enforcement powers. But the mere delegation of these duties and the empowerment of the PCAOB simply inject yet another layer of regulation and enforcement. It does not address the issue of corporate governance.

Section 201: It shall be unlawful for a registered accounting public accounting firm . . . to provide to . . . contemporaneously with the audit, any non-audit service including:

(1) Bookkeeping and other accounting services.
(2) Financial information systems design and implementation.
(3) Appraisal or valuation services.
(4) Actuarial services.
(5) Internal audit outsourcing.
(6) Management or human resource functions.
(7) Broker or dealer or investment adviser, or investment banker services.
(8) Legal and expert services unrelated to the audit.
(9) Any other service that the PCAOB determines by regulation is impermissible.

Conceivably, this section was crafted to address two distinct concerns. First, additional consulting revenues may increase the auditor's dependence on any given client, and secondly, some consulting services create conflicts of interest that may bias the auditor's opinion rendered on the financial statements that partially reflect the auditor's own work (such as financial information system design and implementation). The ability of these rules effectively to ameliorate the conflict of

interest is dubious. With respect to the first concern, an indefinite stream of audit fees continuing into the future is sufficient temptation (consider Enron's audit fees of $25m a year). As to the second concern, a troublesome trade-off comes to mind. Rendering some of these barred consulting services endows the auditor with intimate knowledge of the client that makes him or her (paradoxically) less informationally dependent on the client's management. Barring the services therefore could potentially diminish the auditor's independence rather than enhancing it.

Section 201 attempts to remove some of the temptations that may influence the auditor, but it could be imagined that auditors would engage in a strategy that takes the form of auditing one issuer and providing prohibited services to another issuer; in the end the total market for audit and prohibited services remains the same, and the total revenue of a given firm would not appreciably change.

Section 301 mandates that 'The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.' The section continues on to stipulate and describe such matters as independence of audit committee members, procedures for resolving complaints, authority to engage advisers and funding.

But unfortunately, legislating independence of audit committee members, or for that matter, all of the board of directors' members, does not in fact make members independent in reality. Independence is an unobservable state of mind, often generated by subtle incentives that are not affected by the Act's rules. For example, board of directors or audit committee members could have their interests aligned with the chief executive officer or the chief financial officer because they depend on the latters' recommendations for becoming members of other company boards, etc.

Section 302 mandates 'that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted . . . that'

1 The signing officer has reviewed the report.
2 Based on the officer's knowledge, that the report does not contain any material misstatement or omission rendering it misleading.
3 Based on the officer's knowledge, the financial statements fairly present the financial condition and results of operations for periods presented.
4 The signing officers are responsible for establishing and maintaining internal controls and having the internal controls evaluated within 90 days of issuing the report.

Other parts of the Act deal with enforcement and penalties against officers and directors.

It would appear that the authors of the Act have concluded that there was a need for an additional regulatory agency, with very substantial powers, to remedy the deficiencies of the SEC that already has very substantial regulatory and enforcement powers; the creation of a 'SEC Light' does not seem to be the answer.

WHAT IS CORPORATE GOVERNANCE?

The CgLit does not provide either an operational definition of 'corporate govern-

ance' or a specific set of standards that could guide the behaviour of corporate officials in a way that would both fulfil their fiduciary responsibilities and bring into existence 'corporate governance'.

The *Wall Street Journal* on 27th October, 2003[2] devoted a whole separate section to corporate governance. The following provides an excerpt of a few parts of the section. It is the authors' belief that the excerpts will speak for themselves and that they make the case that the words 'corporate governance' form a term in search of meaning; FSI makes a significant contribution, in operational respects, to its definition.

> 'The role of a corporate board member has never been more crucial — and more confusing. What exactly are directors supposed to be doing, anyway?'

> 'The Sarbanes–Oxley Act, which took effect in July 2002, and subsequent rules proposed by two stock exchanges have resulted in dozens of new rules and procedures that have added to directors' duties. They include more regularly scheduled meetings of independent directors separate from company management, more careful oversight of accounting by the board audit committees — and more potential liability if things go awry. But amid all the responsibilities and higher risks, there remains unanswered a simple question: What makes a good director? Boards, after all, have learned over the past two years what *not* to do. Now they need to figure out what *to* do.'

Lawrence Rout in the Editor's Note[3] offers the following:

> 'Corporate governance. It's hard to find a phrase that has generated as much attention over the past two years, and as much confusion.
>
> We know the problems at Tyco, WorldCom and Enron arose partly because of it. We know that regulators and Congress have stepped in to try to fix it. We know that shareholders are demanding more of it. We know that companies are promising to do it better.
>
> But that still leaves an awful lot of questions. Such as: What exactly is corporate governance? Who's responsible for it? How has it changed? What reforms are ahead? And, perhaps most important, what does it mean to do it well?'

This paper will show below that FSI contributes significantly to both the emergence of 'corporate responsibility' and to a set of operational standards that, if followed, will satisfy the corporate officials' fiduciary responsibilities.

Governance is the process through which an organisation is directed, controlled and regulated. In formal organisations, governance is ultimately the responsibility of the officials at the top of the organisation's hierarchy; nevertheless, it is an organisation-wide process. Governance, in general, entails the selection of goals, strategic planning, tactical implementation of the plan and eventually reporting to the organisation's stakeholders the wellbeing of the organisation as well as the results that have contributed to the change, if any, in the organisation's wellbeing that occurred over a given period of time. Jensen (2000) includes a paper by Jensen and Chew which opens up with a clear statement of the problem that underlies corporate governance:

> 'Corporate governance is an issue of great concern to owners of common stocks because stockholder wealth depends in large part upon the goals of people who set the strategy of the corporation. Who is the boss, and whose interests come first?'[4]

They go on to say:

> 'The objectives of corporate managers often conflict with those of shareholders who own the company. Laws and regulation enacted since the 1930s have effectively put most of the power in the hands of management, frequently at the expense of the interests of the owners of the corporation. At the same time boards of directors have tended to go along with management and to ignore the interests of the very party they were created to protect.'[5]

No one would want to perform the function of management in the absence of the ability to be held blameless for poor performance. Society, in exchange for the grant of blamelessness, has imposed on management the responsibility to act ethically and legally, and in the best interest of the enterprise's stakeholders. Nevertheless, this bargain carries with it certain risks of malfeasance on the part of management. This potential errant behaviour is in large part a consequence of the conflict of and divergence in interests that this kind of arrangement can produce. The best remedy for such a latent condition is relevant, timely and reliable information; it is easier said than done. The difficulty that arises is that the dissemination of complete information violates the organisation's need for secrecy that is a mainstay of preserving its competitive advantage. But more damaging are the incentives to hide information or, even worse, falsify information in a way that serves the selfish interests of management.

Having said that, an information regime can be established that satisfies the need for secrecy on the one hand and for adequate communication with the organisation's stakeholders on the other hand, while, at the same time, eliminating the incentives to misrepresent. It is the contention here that the governance system which includes FSI will satisfy society's requirement for adequate communicated information to stakeholders regarding the viability of their contingent claims; the two dimensions that will be transmitted are the results for the reported period from the deployment of the entrusted resources and the implicit risk status of the deployed resources.

The sections below outline a comprehensive accounting model and the FSI system — an auditor's and management's incentive model.

COMPREHENSIVE ACCOUNTING SYSTEMS

The outline of a comprehensive accounting system begins with two fundamental assumptions:

1. Economic organisations are purposive open systems that have recurrent cycles of input, transformation and output of resources.
2. Accounting is the *ex-post* quantification of management's *ex-ante* decisions.

Accounting information is an essential component of an organisation's information mix. There are two types of accounting: decision (managerial) accounting and reporting (financial) accounting. These two types of accounting are not different in kind but represent different portions of an information continuum; in fact, financial accounting makes substantial use of information produced in the managerial accounting phase of the accounting information production process (eg cost of inventory). Similarly, management accounting articulates with financial accounting.

The selection of and use of information is determined by what is deemed to be relevant to a particular class of decision makers; accordingly, managerial accounting is generally idiosyncratic to a given organisation. Because financial accounting is geared to the organisation's outside constituencies, inter-organisation comparability has been adopted as the guiding principle of financial accounting. This is presumably achieved through the

adoption of financial accounting standards or generally accepted accounting principles (GAAP).

The most frequently issued GAAP-based financial statements are balance sheet, income statement, statement of cash flows and statement of shareholders' equity. Even though it is claimed by some that financial accounting is historical in nature, further examination would disclose that much of present day financial accounting entails the impounding of future known and estimated events. This being the case, it could be argued that financial accounting is either the future realisation of the past, or the past acting as a foundation of the future.

Given the centrality of information in the corporate governance process it is therefore critical that the data generating system and information conversion process produce relevant and reliable information; accounting information, for internal and external consumption, is a critical element in the information set. Furthermore, it is critical that management — the informer — has no incentives to misrepresent or omit relevant information. As discussed above, accounting is essentially a 'report card' of management.

FINANCIAL STATEMENTS INSURANCE

In the arena of public companies, where outside capital providers are not privy to the inner workings of the enterprise, as it should be, there is a compelling need to inform them truthfully of the financial status (balance sheet) and performance (income statement) of the organisation. But this requirement raises an obvious conundrum: what is being asked is that management report on itself, which is by its very nature, setting aside malfeasance, inherently an act of subjectivity. Over time the resolution of this dilemma has taken two forms: independent, non-employee members of the board of directors and independent outside auditors. It was assumed that independent directors would be the representatives of the outside stakeholders — their 'eyes and ears' — assuring that the organisation was being operated responsibly, ie in accordance with management's public proclamations regarding the future direction of the organisation, and that the financial statements are a reasonably accurate reflection of the organisation's state and performance. Nevertheless, without some method of independently verifying the effectiveness of the data generating system and validity of the information conversion process their undertaking is a vacuous one. That brings into existence the independent outside auditor, the CPA. The responsibility is now shifted to the outside auditor to carry out, in significant part, the verification and validation functions of the board and the financial reporting to the outside stakeholders.

The current state of affairs between auditor and the organisation, even with the enactment of the Act, manifestly embodies a predicament for the auditor: the auditor is, for the most part, retained by and dependent on management. Without management's cooperation it is virtually impossible for the auditor to carry out his/her assignment. In terms of power, the auditor, in the present arrangement, is always in a weaker position *vis-à-vis* management. This condition translates itself into the auditor being more accepting of management's assertions, claims, estimates and responses. Assuming that the auditor was of a mind to contest management, what is the auditor's recourse? Complaining to the audit committee may or may not work; in the end, if the auditor acquires a reputation as a stickler, the chances are that very few organisations would retain him/her in the future. On the other hand, management can reward a compliant auditor in different ways, not the least of which is allowing the auditor to expend less effort, thereby making the audit engagement more profitable. Of course, dangling a higher probability of renewed future engagements is a potential temptation. The problem for the auditor is that he/she does not have any

levers to use either in regard to management or a 'go along' board of directors. FSI substantially alters the auditor's position in relation to both management and the board.

FSI is a system that causes a realignment of incentives for the auditor, the board of directors and management. As a general proposition, well-constructed incentives encompass the avoidance of undesirable consequences. The realignment of incentives is accomplished when instead of the organisation retaining the auditor it is the FSI carrier that hires the auditor to perform the audit. From this change in arrangement a whole host of consequences naturally flow. One form of FSI, which is referred to as 'exsurance', insures the shareholders against losses in the market value of their securities as a result of a material misrepresentation or omission (MM&O) in the organisation's financial statements. The other form of FSI compensates the organisation directly for the difference between financial statements, as issued, containing an MM&O, and the financial statements that subsequently are judged to be 'accurate'.

In the case of a public company the FSI acquisition process starts with the organisation requesting insurance proposals from FSI carriers. Thereafter, as part of the proxy process which takes place well in advance of the organisation's fiscal year end, the organisation asks the shareholders to vote on one of three propositions relative to FSI coverage: the maximum amount of available coverage and the related premium, an amount of coverage that is less than the maximum coverage that is being recommended by management and the related premium, and no coverage. The combination of maximum available coverage and related premium serves as a timely signal to the securities markets regarding the risk inherent in the organisation's financial statements. Clearly, an FSI carrier deeming an organisation's financial statements less risky, in terms of an MM&O, would be willing to provide a greater amount of coverage at a lower premium.

It is important, at this point, to provide an explanation of the use of the word 'risk' in the context of audited financial statements. The AICPA, SAS47 (AU 312 02) 'Audit Risk and Materiality in Conducting the Audit', defines audit risk as: 'the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that contain a material misstatement'. The present authors explicitly add to that the risk of a material omission or misrepresentation that renders the statements misleading. The literature decomposes audit risk into inherent, control and detection risk.

Inherent risk is defined as: 'the likelihood of a misstatement existing in an account balance or class of transactions that would be material when aggregated with misstatement(s) in other accounts or classifications, assuming that there were no related controls'. There are many potential sources of inherent risk, such as valuations requiring sophisticated calculations and/or extrapolations of past trends, judgments that are sensitive to economic, competitive and technology factors, and the characteristics of the industry in which the organisation operates.

Control risk is defined as: 'the possibility of a misstatement occurring in an account balance or class of transactions that (1) could be material when aggregated with misstatements(s) in other balances or classes and (2) will not be prevented or detected on a timely basis by the entity's internal control'. Control risk can be thought of as the possibility that is intrinsic in any system that the system will fail because of inadequate design, new and unanticipated requirements, mechanical and/or human failure; systems can never be perfect. More importantly, the cost of achieving perfection, even if feasible, may exceed the benefit.

Detection risk is defined as: 'the risk that an auditor will conclude that a misstatement in an account balance or class of transactions

that could be material (when aggregated with a misstatement in other accounts or classes) does not exist when, in fact, such a misstatement does exist'. Detection risk emanates from the fact that auditors rely on such techniques as sampling of data and judgments regarding inherent and control risks.

In the world of auditing, audit risk and quantity and quality of evidence are inversely related. The second standard of fieldwork, AICPA, SAS1 (AU Section 150), requires that the auditor obtain sufficient evidence as a reasonable basis for the conclusion expressed in the attestation report. The factors that influence the auditor's evidence gathering include: materiality, risk, size and characteristics of data populations. The characteristics of the evidence that the auditor seeks include: relevance, source, timeliness and objectivity.

The amount of FSI coverage and related premium impound the audit risk and the quantity and quality of available evidence. FSI makes explicit what is concealed in the current audit environment. The maximum coverage and related premium is information (provided by FSI) that can be viewed as a surrogate measure of the overall riskiness of the enterprise's financial reports, giving the financial statements user an additional dimension of information to factor into his or her decision, an externally directed aspect of corporate governance. With regard to the internal requirement, this information serves as a signal to the board and management that has to be evaluated in terms of what, if any, changes are required.

It could be hypothesised that capital markets would reward organisations that purchase FSI by increasing the market price of their securities and reducing their cost of capital. This benefit flows from a reduction in audit risk because of the insurance against MM&O, and by virtue of the additional credible public information on which to make a decision.

It is claimed that FSI increases audit quality through the realignment of incentives by way of having the auditor retained by the FSI carrier. The basis for this assertion is the shift in the auditor's self interest. In the current audit environment the auditor is subject to currying favour with each and every client; this is only natural. In the FSI environment, being hired by the FSI carrier, the auditor's currying focus is redirected to the carrier. This follows from an obvious supposition: the FSI carrier represents many audit engagements, and in aggregate the fees from all of these engagements far outweighs the fee from any one engagement. So, an auditor who does not protect the carrier's interests would be jeopardising his/her continuing retention by the carrier.

In the simplest of ways, auditing can be characterised as the exercise of judgment. In the world of auditing the currying of favour takes the form of the exercise of judgment in regard to the selection of what to audit, of how to audit a given account balance or class of transactions, the sufficiency of evidence, the interpretation of the evidence and the following up on matters that could be construed as problematic. Audit quality can be viewed as the result of the exercise of *professional scepticism*.

The AICPA, in a statement of auditing standards (SAS 1), describes professional scepticism as 'an attitude that includes a questioning mind and a critical assessment of audit evidence'. Because the accounting process involves numerous estimates and judgments, which may or may not be realised in future periods, the best the auditor can do is gather sufficient and convincing evidence that is persuasive. It naturally follows that the more material an item is in the financial statement and the more the value of the item is susceptible to not being fully realised in the future because of the uncertainties that surround it, the greater the need for the auditor to gather evidence to reduce the uncertainty to a level that falls within the

range that would be deemed an acceptable audit risk.

Clearly, improved audit quality is consistent with good corporate governance. In the case of FSI, the carrier's interests and the outside stakeholders' interests are congruent; both will be harmed in the event that the financial statements are materially misleading because of material misstatements or omissions. The improvement in audit quality and information signalling the organisation's state, strength and weakness equip the individuals responsible for corporate governance, that is, the board of directors — the representatives of the shareholders — to carry out their duties.

It can be shown that the total cost of FSI insurance and audit fee, under reasonable conditions, does not exceed current costs to the organisation. With the additional benefits of lower capital costs and the willingness of some stakeholders, for example resource suppliers on credit, to do business with the organisation, economically speaking, FSI is a positive sum game for the organisation, FSI carrier, auditor, stakeholders and capital markets.

In an effort to provide greater insight into FSI, this paper will describe in somewhat greater detail the FSI acquisition process and the benefits to carrier, auditor, capital markets and the insured (organisation).

The FSI acquisition process starts when the potential insured makes a request for a proposal from one or more FSI carriers. The response of the request could either be a declination or a proposal that contains the carrier's offer in terms of the maximum amount of coverage and the related premium and — if requested — an offer for a lesser amount of coverage and the related premium. As noted earlier, these activities occur prior to the distribution of the organisation's proxy statement that currently includes the appointment of the outside auditor. In the FSI framework, there would be the additional item to be voted on, the acquisition of FSI. This circumstance transmits to the voting shareholders and the capital markets a very important piece of information regarding management and the organisation. This signal is the result of a thorough evaluation by the FSI carrier. As part of the FSI carrier's underwriting process, the carrier would examine and evaluate a whole range of items and issues in an effort to limit its potential losses. At the same time, as is the case in any line of insurance, the carrier accepts some amount of exposure, if it did not it would never write any policies. In a competitive market, insurance carriers arrive at an equilibrium of risk and reward trade-off.

The areas of interest to the FSI carrier's underwriting include an analysis and evaluation of such items and matters as:

1 The nature, age, size and operating structure of the organisation.
2 The reputation, integrity and operating philosophy of the organisation's management and its goals and objectives.
3 The organisation's control environment and significant management and accounting policies.
4 The organisation's accounting system and control procedures, the financial state and prior operating results.
5 And whatever else is relevant in the circumstance.

The FSI carrier's aim is to acquire a sense and feel for all of the aspects of the organisation as a basis for making a risk assessment. Ultimately, the carrier's assessment is summarised in its proposal. It could be seen that in regard to the potential of an audit failure, the carrier and the organisation's stakeholders' interests coincide. Moreover, the information impounded in the carrier's proposal is, besides being timely, far more informative to shareholders in terms of the risks associated with their ability to estimate the future returns on their investment. Clearly, audit

failure risk and the risk of misassessing the return on investment are very much related. The carrier, most assuredly, would include in its calculation some measure of the organisation's prospects for future success. This follows from at least two reasons. First, since, as mentioned above, modern financial statements substantially reflect estimates of an organisation's future and, secondly, a review of the recent 'audit failures' reported in the press suggests that unsuccessful organisations tend to throw caution to the wind and engage in actions that could be detrimental to both the carrier and the organisation's stakeholders.

The carrier's review would be undertaken by an independent group (ROAR) that has a range of responsibilities — to **r**eview, **o**versee **a**nd **r**ate. ROAR has two rating functions. First, it assesses the competence and capabilities of auditing firms. Before an FSI carrier retains an auditing firm for a particular audit engagement, the firm has to have passed muster across a range of dimensions, eg audit methodology, quality of staff and supervision, technology support (computerised auditing systems), experience, continuing professional education of staff and supervisors and industry knowledge. Secondly, ROAR is the means through which the FSI carrier gathers the necessary knowledge of the potential insured, as described previously. After the potential insured comes to an agreement with the FSI carrier, ROAR and the selected auditing firm come to an agreement as to the nature and scope of the audit. Thereafter it is ROAR's responsibility to oversee and review, as deemed necessary, the auditing firm's efforts and final product — this activity could be seen as a peer review that is conducted prior to the issuance of the auditor's report. The FSI will only issue the policy in the event that the auditor is prepared to render a clean opinion. In addition, the auditor's report will contain a paragraph describing the amount and conditions, if any, of the coverage.

Because of the importance and variety of ROAR's responsibilities, it will gather under its banner all of the requisite capabilities it will need to fulfil its charge. Its expertise will be recruited from the external and internal auditing ranks, industry, academia and the legal community; whatever is necessary to carry out its important responsibility, it will retain; ROAR can be thought of as a Standard and Poor's in the auditing world.

In the FSI framework the auditor's perspective, as discussed previously, shifts to protecting the carrier's interest in contrast to identifying with the client and its management. In the current arrangement, the auditor can be thought of as suffering from the 'Stockholm syndrome' wherein the captive identifies with his or her captors. Setting aside the issue of economic incentives, it is clear that in the FSI regime the auditor's psychological dilemma — that of being caught between the auditor's professional responsibilities and training and the need to ingratiate him/herself with the client — is dissolved. This has more than a trivial impact on the auditor. Currently, auditors compete against other auditors principally on the basis of price; this causes auditors to cut corners to be profitable. In the FSI structure the auditor will compete on the basis of competence and capabilities; it is in the auditor's interest to be professional and well trained. The demand for auditor excellence from FSI carriers will have a positive effect on the auditing profession as a whole. The pressure from FSI carriers should cause auditing firms and others to invest in developing new audit approaches and methods, ultimately continually raising the quality of auditing. An analogy can be drawn between the impact that automobile insurance companies, through their Automobile Safety Institute, had on auto safety, and the future quality of audits; the free market has always been a great motivator of innovation.

Capital markets allocate financial capital to those applications that in the market partici-

pants' judgment provide the greatest return with the lowest associated risk. Market participants arrive at their decisions through the evaluation of information. Risk is represented in the finance literature in summary measures such as the variance, skewness or covariance characterising the probability distribution of future returns. Impounded in the risk measures is the risk of an audit failure. This risk can best be thought of as the probability of misstating an entity's financial condition and performance for a reported period. By eliminating or substantially reducing the likelihood of an audit failure, the moments of the probability distribution shift in a way that can have an impact on the investor's decision. The shift is a result of the additional available public information. Counteracting the remaining perceived audit failure risk is the amount of FSI insurance covering the financial statements. At the end of the day FSI makes the allocation of resources more efficient and effective.

Ultimately, it is the 'insured' that has to perceive a benefit from the acquisition of FSI. The 'insured' benefits in a number of ways. One way is through the lower cost of capital brought about either by being charged lower interest rates on its debt, or by raising equity capital through the sale of stock at higher prices. Besides the cost of capital benefit, there are such benefits as the imprimatur of the FSI carrier, the willingness of suppliers to extend credit possibly at lower prices because of the improvement in the collectibility of its receivable, and the favourable message that FSI sends out to such stakeholders as customers and employees.

Lastly and very significantly it is the behaviour of management that is the central focus of the Act, but from a social cost perspective it could be argued that it is highly inefficient. It is not too much of a stretch to say that, for the most part, managements and auditors across the public company landscape conduct themselves in a responsible and forthright manner. That being accepted, the imposition by the Act, across the board, of costly requirements in an effort to impede the relatively few misbehaviours is clearly a spreading of an uneconomic burden.

In the 10th February, 2004 edition of the *Wall Street Journal*[6] there is a front page article entitled 'Companies Complain about Cost of Corporate-Governance Rules'. The article goes on to say:

> 'Some US companies are complaining that new rules aimed at improving corporate accountability will cost them in dollars and in time this year.
>
> Most of the rules stem from the 2002 Sarbanes–Oxley Act, which Congress enacted to beef up corporate governance in the aftermath of accounting fraud uncovered at Enron Corp., WorldCom Inc. and elsewhere.
>
> Congress and the Securities and Exchange Commission have imposed additional regulations that are just now starting to hit bottom lines. The changes are aimed at toughening corporate accountability to restore investor confidence. Advocates say they will help companies avoid costly problems down the road.'

The argument that the advocates present, namely, that it 'will help companies avoid costly problems down the road' does not wash. If the present authors' reading of the historical record is valid, ie that it is only a very small percentage of public companies that engage in 'cooking the books', then it does not follow, as the advocates claim, that the overwhelming number of responsible public companies and their shareholders should be burdened with a wasteful cost so that the few will be deterred from engaging in fraudulent activities. From a social cost point of view, an effective system should cause only those organisations that are

capable and inclined to misinform their shareholders to bear the cost. All others should not be so encumbered.

In the FSI framework, organisations that are deemed, by ROAR, to be risky in the sense of audit risk will either be denied FSI coverage or if offered coverage the amount will be relatively small and the premium relatively large. That being the case, it is reasonable to assume that management will adjust its behaviour and/or business policies so as to make its organisation's securities appealing to investors. Conversely, management will find it in its self-interest to reduce the audit risk through a policy that focuses on the interests of its organisation's stakeholders.

In summary, corporate governance is a function of the quantity and quality of information, FSI is an instrument that enhances the information flow and positively affects management's behaviour — a positive sum game for all of the organisation's stakeholders.

References

1 Sarbanes–Oxley Act of 2002. Pub. L. No. 107–204. 116 Stat. 745 (2002).

2 Hymowitz, C., Corporate Governance (A Special Report); How to be a good director, *Wall Street Journal*, October 27, 2003, p. R.1.

3 Rout, L., Corporate Governance (A Special Report); Editor's Note, *Wall Street Journal*, October 27, 2003, p. R.2.

4 Jensen, M. C. (2000) *A Theory of the Firm*, Harvard University Press, Boston, MA.

5 *Ibid.*, at 9.

6 Solomon, D. and Bryan-Low, C., Companies complain about cost of corporate-governance rules, *Wall Street Journal*, February 10, 2004, p. A.1.