Financial Statement Insurance

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Introduction

The largest corporate bankruptcy filed in the U.S. that of Enron Corp in 2001 was preceded by a string of disclosures about the restatements of their financial statements.[1]The presence of such errors that required restatements of the financial statements brings into focus the salience of two inter-related needs. The first is the need to assess the quality of the information contained in the financial statements as a basis for making projections about the future. The second is the need to actually make projections about future cash flows and aggregate these into a value for the security. Even if one assumes that accurate models are available for projecting cash flows, uncertainty about the quality of the financial statements can lead to pricing distortions and inefficient market allocations.

Several causes have been suggested as culprits that contributed to the current state of affairs. Among these is the tendency by management to inflate stock prices for personal gain through deceit, `cooking the books' along with the consequent misrepresentations in financial reporting; investors' irrational exuberance, infectious greed, and foolishness; the bursting of the bubble; the impoverished morality of CEOs; the bright line financial reporting standards, which have encouraged auditors to acquiesce in accounting gimmicks, and other unethical behavioral practices, and more importantly, the failure of the auditing profession to fulfill their 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 that is endemic to the relation between the clients -- management (the principal) and the auditor (the agent).

Are Auditors 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 consulting services to

[1] As catastrophic as this event may have been, it proved to be only the beginning of a series of stunning revelations of accounting irregularities by major corporations that were the darlings of Wall Street: WorldCom, AOL, Metromedia Fiber Networks, Qwest Communications; the list goes on and on. The number of restatements keeps rising, from 50 a year in the early 1990s to well over 200 a year in 2001.

the audit client: had he not been co-opted by the lure of large fees, the auditor 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 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. Indeed, the visibility, frequency and magnitude of "audit failures" has increased substantially over the last few decades. Reasons for this possibly include a more aggressive plaintiffs bar or 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 was associated with the largest and best audit firms; what are the likely causes of this astonishing observation?

One likely explanation lies in the dramatically changing nature of business and of accounting and auditing over the last few decades. We witness a movement from an industrial economy to an information economy. The impact of this dramatic change on the audit process is massive. In the industrial economy of fifty years ago the primary focus of the auditor was the validation of data, when the client's books and records were maintained manually. Major efforts were expended by the auditor to verify the records through such activities as 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. This circumstance provided the auditor with an opportunity to look back and further validate his/her assessment of the data and valuations as of the statement date. One recognizes that at the time there were long-term projects, which were accounted for on a percent of completion, but auditors had developed adequate methods and techniques such that they were confident in the carrying values of these projects.

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. The computer, from the auditor's point of view, could be viewed as a mixed blessing. On the one hand, the computer has substantially expanded the amount and quality of data available to the auditor - data overload - and on the other hand, because data is produced and maintained in electronic form the auditor is at the mercy of the data processing systems.

The movement from tangible to intangible assets with very long lives and from liabilities whose principle and terms are known and specified to liabilities whose principle 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.[2] 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)[3]. 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, 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. This is a phenomenon akin to a "Stockholm Syndrome", wherein the captive identifies with his or her captor. 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.

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[2] 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!

[3] Joshua Ronen & Varda (Lewinstein) Yaari, "Incentives for Voluntary Disclosure", 5, Journal of Financial Markets. Pp. 349-390.

A major flaw, one 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 in this situation: aaccording to sound principles of corporate governance, auditors are supposed to be the agents of the shareholders. But in practice, it is management that engages the auditor. Although shareholders vote on management's recommendation of which auditor's services to hire, the decision is effectively made by management. This arrangement creates an inherent conflict of interest for the auditor. It is the management of the company that engages the auditor and ultimately pays for the 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.

It is altogether clear that under the current institutional setting, 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. The problem is that, as a result of these circumstances, the auditor ends up seeing things through the eyes of management and may even believe that he/she is doing the right thing.

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, I believe that the solution lies in market mechanisms that eliminate the perverse incentives of gatekeepers, most notably the auditors. We need an institutional mechanism that eliminates the conflict of interest auditors face and properly align their incentives with those of shareholders.

The solution proposed is a financial statement insurance mechanism that promotes improved alignment of incentives, and hence better quality audits. The introduction of financial statement insurance can significantly mitigate market inefficiencies arising from uncertainty regarding the quality of financial statements. The basic structure of Financial Statement Insurance (FSI) may be described as follows. 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.

In proposing Financial Statement Insurance, I am arguing that the intractable conflict of interest imposed on auditors cannot be rectified through legislation, regulation, enforcement, or litigation as long as auditors are engaged by the management of the firms they audit. Instead, what is needed is an agency relationship between the auditor and an appropriate principal whose economic interests are aligned with the goals of promoting better disclosures and greater economic efficiency. In other words, there is the need to align the interest of shareholders (acting as the principal) with the auditor (acting as the agent).[4] The only way to remove the inherent conflict of interest facing the auditor is by severing the agency relation between the company’s management and the auditor. In the context of a free market mechanism, insurance carriers can serve the role of such a principal. 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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To reiterate, 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 that 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. 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

[4] Such a realignment of interests would contribute towards restoring the “complete fidelity to the public's trust" that Chief Justice Burger insisted on in a celebrated opinion: “By certifying the public reports that collectively depict a corporation’s financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust" [United States v. Arthur Young & Co., 465 U. S. 805, 817 18(1984)]

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 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 that has been selected to perform the audit. It is reasonable to assume as a matter of effectiveness and efficiency it would be the auditor that would be 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. (details may be found in Ronen (2002))[5].

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.

It is envisioned that the company, in its proxy statement, would provide the 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, which is being recommended by management, and the related premium and (3) no insurance. There are two benefits that emerge from this scheme. Firstly, it creates an incentive for shareholders to become more active in corporate governance. the second benefit flows from the fact that 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.

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

Size of Coverage

The magnitude of potential liability arising from financial statements misrepresentations is one of the key considerations in the FSI scheme. The issue is whether losses stemming from

[5] 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.

misrepresentations are likely to be too large to be covered by insurance companies. I do not believe this is the case. Financial statement misrepresentation losses exist in the current regime and are borne in one way or the other by several players including investors, companies in the form of class action litigation settlements, insurance companies through D&O and malpractice settlements, and the audit firms and the firms themselves through premium paid on D&O insurance. The effective "premium" companies and auditors now pay is considerably larger that the nominal premium paid for D&O or malpractice insurance. In other words, if losses result from accounting irregularities, someone must be bearing them: either companies themselves through premia and litigation settlements, insurance companies in D&O settlements, the auditors, and or the investors. All things considered, the cost of recoveries through a combination of D&O insurance and settlements currently borne by investors in audit failure cases would be necessarily lower when the auditor's incentives are aligned with those of investors. Thus, the total premia needed to accord investors the same level of recoveries under the current system, including the current D&O premia, audit fees, malpractice premia, and the expected settlements cannot be greater. On the contrary, total losses under FSI are likely to be less because of the incentives of companies to minimize their cost of capital, which will induce them for a given coverage to minimize premia by improving the financial statements quality and hence minimize the loss causing irregularities. This would be reinforced by the better quality audits engendered by the superior auditors' incentives alignment. In other words, even keeping the coverage and the extent to which investors' losses are recouped at no more than it is today we have an improved audit quality, mitigated conflict of interest and more efficient resource allocation.

I should point out that 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 the better audit quality and the incentives companies have to improve the quality of their financial statements so as to decrease their cost of capital. Were companies to demand (and are granted) large coverage, the FSI model can be readily adapted to handle this situation. Unlike insuring against non-tradable assets such as personal accidents, building fires and the like, insurers can hedge their exposure in underwriting coverage for securitized assets (equities) by devising suitable derivatives strategies to "reinsure" their exposure in capital markets.

Under the FSI proposed mechanism, the insurers, who strictly speaking need not in fact be insurance companies, can purchase options to hedge the risks, or better yet, purchase specialized conditional puts the exercise of which would be triggered by the occurrence of the insured event: misrepresentation or omission. Also note that not all companies (and hence securities) carry the same financial statement risk: some are better than others. Hence, there is a possibility of constructing portfolios that are diversified on the dimension of financial statement risk: the contribution of one security to the aggregate financial statement risk of the portfolio is less then its own financial statement risk.

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. I 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.

Collusion between Firm and Insurance Carrier

Collusion between the company being audited and the insurance company is not probable under the FSI regime. It may be argued that since the audited firm chooses the FSI carrier out of a list of possible companies, it will be in the interest of the insurance company to offer a premium no higher than the competitive rate in order not to be excluded from the FSI market. The potentially colluding insurance carrier will have to be compensated for the loss by charging unjustifiably high premium on other policies underwritten for the benefit of the audited company.

Such a carrier faces two potential consequences both of which are adverse: first, the carrier would have to publicize the lower premium as a requirement of the FSI scheme. This would result in a higher price for the stock and higher capitalization which in turn would increase the losses to shareholders upon an event of omission or misrepresentation. Since the losses are an increasing function of the firm's market capitalization, the more inflated the price the larger the price-drop in an event of audit failure. The expected coverage cost incurred by the insurance carrier within the limit of the policy would increase offsetting any gains from overcharging on other services. Secondly, since the audit report is publicly observed, the audit firm will have to acquiesce to the collusion between the carrier and company being audited as well for this to work. Thirdly, insurance carriers are subject to a very strict audit by the various regulatory insurance bodies. The observation of too low a premium compared with similar firms would invite regulatory scrutiny and the possible establishment of higher reserves which would impose additional costs on the carrier. Furthermore, it suffices to require public disclosure of all premia (on all insurance lines) paid by the FSI-insured to deter a conspiracy.

Possible Perverse Incentives

Is it possible that to avoid the payment of potential shareholder claims an insurance carrier – principal – and hence, the auditor – its agent – intentionally overlook the need for a restatement that GAAP would indicate as necessary? It is tempting to think that under FSI such a perverse incentive might exist. Upon careful scrutiny, however, it becomes apparent that this is not the case. FSI in year t covers errors and/or misrepresentations that occur during the year for which the financial statements are insured – year t. Hence, a later restatement, say at year t+m, implicating he financial statements for year t may establish a claim against the carrier insuring year t. Superficially, this may suggest that the insurer would prefer covering up the discovery by its auditor, and hence avoid the potentially loss-causing restatement. But if the error or misrepresentation were material, it will most likely come to light eventually, say in year t+n, n>m. if revealed in year t+n, the insurer would be then liable up to the amount of the policy limit, except that the damages it would have to pay under the policy will be much higher due to the additional shareholders who would have purchased the stock at the inflated stock prices between year t+m and year t+n. As a result, there would be a disincentive to such a counter-productive strategy.

Conclusion

Several causes have been advanced in the media for precipitating an accounting meltdown: irrational exuberance, infectious greed, the stock market bubble, moral turpitude of executives, unethical accountants, non-audit services, and related ills. I have argued that the inherent conflict of interest in the auditor-client relationship combined with the unobservability of financial statements quality, together, are likely culprits. 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 stakeholder losses.