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The Financial Statement Insurance Alternative to Auditor Liability

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Abstract

These articles evaluate using financial statement insurance (FSI) to reduce the frequency and magnitude of audit failure. The FSI concept was pioneered by Josh Ronen, NYU Accounting Professor, who has modeled its economic aspects. My paper examines FSI's efficacy from policy and legal perspectives. I conclude that while the model is not perfect, it promises considerable advantages over the current model. While some of the existing system's imperfections are sustained or reappear in different guises, none of the existing imperfections appears to be aggravated and the rest likely are mitigated significantly. So I prescribe a framework to permit companies, on an experimental-basis and with investor approval, to use FSI as an optional alternative to financial statement auditing backed by auditor liability.

THE FINANCIAL STATEMENT INSURANCE
ALTERNATIVE TO AUDITOR LIABILITY

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**PRESENTATION TO THE
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1. Motivation. These articles evaluate using financial statement insurance (FSI) to reduce the frequency and magnitude of audit failure. The FSI concept was pioneered by Josh Ronen, NYU Accounting Professor, who has modeled its economic aspects. My paper examines FSI's efficacy from policy and legal perspectives. I conclude that while the model is not perfect, it promises considerable advantages over the current model. While some of the existing system's imperfections are sustained or reappear in different guises, none of the existing imperfections appears to be aggravated and the rest likely are mitigated significantly. So I prescribe a framework to permit companies, on an experimental-basis and with investor approval, to use FSI as an optional alternative to financial statement auditing backed by auditor liability.

2. Key Contributions. FSI contributes two key advantages. First: conventional wisdom sees the conflict arising when clients pay auditors as an unavoidable fact of life. With FSI, companies buy insurance policies and insurers hire and pay auditors to perform audits, making the auditor's boss insurers, not management or audit committees. Following the proverb *whose bread I eat, his song I sing*, when auditors are paid by insurers rather than those they audit, audit quality should improve. Auditors have greater power to pressure managers to apply accounting policies promoting more reliable financial statements.

Second: conventional auditing results in a standardized audit report providing no comparative or statistical information about financial statement reliability. Except in the unusual cases when auditors provide qualified or adverse opinions, all audit reports say exactly the same thing. With FSI, insurers gauge financial statement reliability and reflect this in the policy premium they charge a *particular* company for a *particular* level of coverage. This premium-coverage mix creates a transparent financial statement reliability index providing financial statement users with specific, digestible public information about the quality of a company's financial reporting.

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3. Reforms. Reforms in Sarbanes-Oxley and PCAOB's auditing standards address auditor independence by putting supervision in the audit committee rather than in managers, restricting non-audit services, and enhancing oversight. These likely help reduce audit failure. But: (1) companies still pay the auditor and (2) while new audit reports on internal control that will begin to be issued in 2005 may provide narrative disclosure from auditors about financial statement reliability, they will not provide a statistical measure of reliability that enables intercompany comparisons.

4. Other Proposals. Likewise, pending proposals appearing in the literature could improve audit quality. Examples include (1) assigning auditors to companies randomly, which mitigates capture risk though not the other problems arising from companies paying auditors or opacity in audit opinions and (2) creating strict auditor liability by establishing an *ex ante* damages formula intended to raise the stakes auditors face for audit failure. Proponents of the latter approach consciously attempt to make auditors act more like insurers, an attempt FSI makes complete. Debate concerning the latter approach also shows the difficulty in setting optimal liability standards and damages measures, which FSI accomplishes by using market-based policy coverage to set pre-determined caps on total pay outs.

5. FSI Concept. To recapitulate somewhat, under FSI (1) companies buy insurance policies for a given premium and coverage mix, based on investigation, yielding a financial statement reliability index that should be far more informative than the standard opaque audit report; (2) the insurer engages and pays the auditor to conduct the audit, making the auditor more beholden to the insurer, not to management—and still adhering to auditing's own professional standards (in GAAS) and federal regulation (SEC constraints); and (3) financial misstatements yield policy payouts up to the pre-determined policy coverage level.

6. Imperfections. FSI is not perfect. Existing imperfections endure or reappear in different forms. But its two key contributions shrink the frequency of manifestations. For example, under FSI, insurers and their auditors have incentives to detect and correct discovered irregularities in any given year's audit. But they may be tempted to suppress discoveries made in later years covered by a previously-issued policy. Auditors face such temptations under the existing system. FSI's two key contributions should make this situation arise less often.

Another concern is skimming, the risk of a race-to-the-bottom among insurers to increase premium volume by offering lenient audits. Again, kindred opinion-shopping can occur in existing audit practice. Under FSI, even if insurers wish to play this gambit, auditors would continue to face professional, reputational, and SEC constraints that should interfere with such efforts.

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On balance, while these concerns are real and incrementally detract from FSI's appeal, overall FSI does not threaten to aggravate the existing system and in many fundamental ways should mitigate existing imperfections.[1]

7. FSI as *Sui Generis*. Beyond these structural and public policy questions lurk more numerous intricate matters of state insurance law. FSI would be governed by state insurance law, yet obliged to serve goals of federal securities regulation. This will be facilitated by FSI's *sui genersis* character, meaning that while it bears superficial resemblance to other insurance, FSI is fundamentally different. It is not like D&O insurance, which is prospective; entails no or limited insurer investigation; and focuses on the behavior and performance of human beings. FSI is more akin to title insurance, which is historical; covers assertions that are based on imperfect information; and entails significant insurer investigation.

In fact, FSI is more akin to other recently-developed insurance products. Examples include tax opinion insurance and fiduciary audit insurance: a professional's opinion based on investigation is backed by insurance. (In tax opinion insurance, typically a tax lawyer evaluates the tax treatment of a proposed transaction and in fiduciary audit insurance an ERISA lawyer evaluates an ERISA plan's compliance with law and company policy.) Another example is representations and warranties insurance, increasingly used in private M&A transactions. (For example, a seller represents that its financial statements fairly present condition and results in conformity with GAAP; an insurer engages an auditor to review the statements and backs the rep with insurance).

FSI's *sui generis* character means it can be created on substantially a blank slate; these analogous products mean creating it can be informed by a range of existing insurance market practices and insurance law principles.

8. FSI Process. To illustrate some of the insurance-related issues, in the paper, I provide a walk-through of the FSI process. In this lecture, I will not burden the audience with the details of this walk-through, which are somewhat intricate, except to note four points: (1) the insurer investigates before offering policy terms, including premium and coverage; (2) adoption of FSI is subject to a security holder vote—companies can opt in or out of FSI; (3) FSI policies become effective only upon an auditor issuing an unqualified audit opinion.; and (4) policy terms will govern the claims settlement process. In the articles, I examine in detail various policy terms that affect FSI's efficacy as to each of these points. Here I can highlight a few for illustration.

9. Premium-Coverage Mix. As to the premium-coverage mix, it is based upon the insurer conducting, through an auditor it hires, an assessment of a company's financial misstatement risk. This includes examination of its control environment, historical

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[1] The articles evaluate these and other limits further, including suggestions for minimizing them: as to suppression, for example, imposing stiff penalties and as to skimming suggesting approaches to insurer oversight.

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reporting practices, accounting complexities, the role of judgment and so on. The resulting index will be most useful to the extent it reflects this risk assessment.

But the mix can also be influenced by various policy terms. To maximize the informational content of the mix while allowing substantial freedom of contract in policy terms, the article shows how some terms can be tailored while others must be immutable. Any that are tailored must be disclosed, along with their effect on the premium-coverage mix. Examples include deductibles and other self-insurance.

An example of an immutable term is that coverage must be primary rather than excess and not contain any other-insurance clauses. These are clauses that rank overlapping insurance policies, making them either *pro-rata* or applicable only in excess of coverage supplied by other policies. FSI must be primary or else managers could load up on expensive D&O policies to increase FSI coverage and/or reduce FSI premium, obscuring the signaling validity of the resulting index.

10. Claims. This could also protract the claims process. Indeed, many policy terms relating to the claims process require attention to evaluate and promote FSI's efficacy. The critical point about the scope of claims is that policies must be occurrence policies, not claims made. That is, they cover a set of financial statements for some period of future time (claims-made policies cover claims made during a given period without regard to when they arose). Numerous other policy terms must be specified to enable the claims process to work effectively, including (1) notice from any reliable source; (2) an investor representative designated in the policy must be authorized to prosecute actions; (3) certain insurer defenses must be limited, including application fraud and the fortuity requirement; and (4) insurers must owe good faith duties to investors, not companies.

11. Authorizing Legislation. The article published in the *Connecticut Insurance Law Journal* (vol. 9, 2004) presents the draft text of a model FSI Act, along with commentary. It uses the federal securities law approach to public debt instruments under the Trust Indenture Act of 1939 to specify mandatory policy terms and then allow for substantial policy tailoring accompanied by disclosure.

12. Conclusion. While FSI holds considerable promise, it is bold and somewhat radical, so I'd endorse proposing it on an experimental basis. I also recommend making it optional rather than mandatory given that the cost-benefit calculus may vary across firms and for different shareholder groups or capital structures.

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