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A proposed corporate governance reform: Financial statements insurance

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Abstract

The inherent conflicts of interest in the auditor–client relationship and the unobservability of financial statement quality are likely culprits in the recent corporate scandals such as Enron and WorldCom. The solution proposed here is a financial statement insurance (FSI) mechanism. Instead of appointing and paying auditors, companies would purchase financial statement insurance that provides coverage to investors against losses suffered as a result of misrepresentation in the financial reports. The coverage and the premiums would be publicized. The insurance carriers then would appoint and pay the auditors. Those announcing higher limits of coverage and smaller premiums would distinguish themselves in the eyes of the investors as companies with higher quality financial statements. In contrast, those with smaller or no coverage or higher premiums would reveal themselves as having lower quality financial statements. Every company would be eager to get higher coverage and pay smaller premiums, lest it be identified as the latter. By transferring the hiring decision to the insurer, this scheme eliminates the auditor's inherent conflict of interest. The publicization of the coverage and the premium credibly signals 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 provides companies with incentives to improve them. Thus, FSI will result in fewer misrepresentations and, accordingly, in fewer suits and smaller shareholders' losses, as well as a more efficient allocation of resources.

JEL classification: G22; G18; G28; K22; L22; L51; M41

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1. Introduction

The cascade of recent audit failures has given rise to a regulatory initiative, the Sarbanes-Oxley Act of 2002 (the Act), and to an ever growing commentary on "corporate governance," a

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major theme of which is the role of ''gatekeepers'' and, in particular, that of auditors. Arthur Levitt (2002, page 116) complains:

''More and more, it became clear that the auditors didn't want to do anything to rock the boat with clients, potentially jeopardizing their chief source of income. Consulting contracts were turning accounting firms into extensions of management—even cheerleaders at times. Some firms even paid their auditors on how many non-audit services they sold to their clients''.

The issue of auditor independence (or its absence) has occupied a major place in the debate over the failure of corporate governance. The Act seeks to address the problem by increased regulation and penalties, empowerment of audit committees, and reduction of the auditor's involvement with the client. But the Act does not untie the auditor/management knot; without realignment of the auditor's incentives and the establishment of a corporate governance framework, matters will return to the status quo ante. This paper introduces a financial statement insurance scheme designed to eliminate conflicts of interest that plague the auditor–client relationship and, at the same time, to credibly signal the quality of financial statements. This is expected to result in security prices that reflect the differential qualities of financial statements and thus become better guides to resource allocation.

Clearly, audit failures are not the sole reason for the debacles in the financial markets. Diverse causes have been suggested: the greed of the 1990s, the market's ''irrational exuberance'' (Greenspan, 1996), executives' cooking the books to maintain inflated stock prices (Jensen, 2004), the escalating use of executive options, that magnify incentives to manage earnings (Jensen et al., 2004), waves of acquisitions using inflated stock, and so on. Such forces could in turn exert great pressure on auditors to acquiesce in dishonest reporting. Sifting among these causes is a diagnostician's nightmare.

Regulators have been busy trying to address corporate governance failures manifested in the workings of boards of directors and of audit committees. Section 301 of the Act, for example, stipulates and describes such matters as independence of audit committee members, procedures for resolving complaints, authority to engage advisers, and funding. It is doubtful, however, that these provisions will be effective. Legislating the independence of audit committees or directors does not, by itself, induce it. Even a cursory analysis of their incentives and motivations suggests that directors and audit committee members are themselves subject to an agency problem not significantly different from that perverting the relation between managers and shareholders: they wish to be re-appointed to their board positions. Pearl Meyers and Partners (2002) report average director compensation in the 200 largest US corporations in 2001 of $152,626. Good relations with the CEO and his team also bestow valuable benefits beyond the immediate monetary rewards, including social connections, prestige, and other opportunities. For example, directors or audit committee members could have their interests aligned with the CEO or CFO because they depend on the latter's recommendations to become members of other company boards, etc.

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