

Accounting: progress may lie in insurance

Joshua Ronen is an advocate of financial statement insurance as a way to improve the integrity of company accounts. Here he outlines the model, while Michael Mainelli looks at how it can be applied to the UK



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Auditors are the main gatekeepers for financial probity, and audit failure is one of the most important reasons why financial scandals occur.

While nominally shareholders appoint auditors, this is actually down to the public company's management, which also structures their fees and assignments.

There is an inherent conflict of interest in this cosy relationship. The US Sarbanes-Oxley Act 2002 sought to offer a partial remedy by prohibiting some non-audit services, but an indefinite stream of future audit engagement is a potent temptation. For example, the Houston office of Arthur Andersen received \$25m a year of fees from auditing alone.

Instead of management structuring the arrangement with the auditor, it should be left to an agency that has a much closer relationship with the company's shareholders and, therefore, a closer investment in the auditor's views. A good candidate would be an insurer, for example an insurance corporation, an investment banker or a government corporation.

The company should solicit proposals for financial statement insurance (FSI) from the insurer for the benefit of the shareholders. FSI would insure shareholders against any losses that they may incur as a result of omissions or misrepresentations in financial statements. The insurer would undertake an underwriting review using independent experts who would

probably consist of retired audit partners, financial analysts and risk management experts.

The review panel may, for example, examine the company's internal auditing and control systems; its management compensation structure and incentives; the occurrence of earnings or negative earnings "surprises" and the market's response; and the corporate governance mechanisms that exist within the company.

Insurers would be able to assess the risk and price the insurance. Their proposals would be submitted to the company's management who would then submit its own to the shareholders. Their decision and the coverage and premium would then be published. The audit fee, now paid by the insurer instead of the company, would also be published.

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Investors are not only subject to the risk of business failure, but also to the risk of misinformation – the unreliability of the information provided in the financial statements – and would pay a premium for reduced information volatility. An investor will be able to ascertain that a company with a higher premium will carry a higher risk, meaning its stock would fetch a lower price.

Conversely, a company with the same coverage, but a lower premium, will indicate that the underwriters had found a lesser risk of omission and misrepresentation, with the resultant higher stock price. The com-

pany would, therefore, have a market-based incentive to improve the quality of financial statements.

FSI ensures that the insurer's interests are aligned with those of the shareholders. Having underwritten the policy, the insurer is committed to minimising the

omissions and misrepresentations that would cause losses to shareholders, and form the basis for future claims against the insurer. The insurer would have to put its money where its mouth is. There is a real liability – there is real money at stake.



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The UK's reaction to financial statement insurance (FSI) has been that it is too complex and more suited to the US's litigious market, which is rules-based rather than principles-based. However, there are three potential ways to launch FSI in the UK that require no regulatory changes whatsoever, but would benefit, through competitive advantage, three distinct commercial constituencies: audit firms, stock exchanges and investment funds.

The dominance of the Big Four firms in the UK audit market – PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte – is partially down to the fact that small or medium-sized firms cannot effectively compete. If there were visible, credible signals on the quality of the audit then firms would strive for a higher quality, and underwriters, investment bankers and companies would not shy away from smaller firms.

There is nothing stopping a medium-sized firm from offering FSI. A medium-sized firm could offer to pay out from partner proceeds today. But to go that bit further they need to team up with an insurer that already has exposure to the risk of financial statements omissions and misrepresentations through policy agreements with company directors. A FTSE 250 FD, however, would need a reason other than price to move to a non-Big Four auditor. "We chose X because they provided a £10m guarantee to our shareholders," is a pretty compelling statement.

AIM, the secondary market of the London Stock Exchange, is an interesting place to look at the potential application of FSI.

As more and more foreign companies seek to list on AIM, maintaining market probity becomes more of an issue. At the same time, foreign companies with their higher costs arising from location, unusual jurisdictions, translation and increased professional services risks, create new challenges for due diligence and listings procedures.

It would be a simple matter for AIM, or any other exchange, to require FSI for new, or even existing, shares. This would push the burden of investigating and reconciling international issuers on to insurers and auditors, but instead of having a pile of paper the exchange would have some level, however small, of financial guarantee. An exchange could make it a listing requirement to have FSI for a specific percentage of the market capitalisation of a company. The FSI requirement might be time-limited, for example, to the first three years. Naturally, the publication of premium and coverage would help provide better "quality-of-listing" information to investors.

Exchanges suffer when companies listed on their markets fail to provide rigorous numbers. The advantage of specifying FSI as a listing requirement is that the exchange would be able to demonstrate to investors the same premium and coverage numbers that indicate financial statements risk, while also being able to gain recompense for harm when companies play fast and loose with "their" market. The exchange could use the monies obtained from being the beneficiary in a number of ways ranging from more due diligence, to better enforcement and advertising.

If insurers offered FSI it might also allow investment managers to create funds targeted at FSI-covered companies. Arguably, these companies should be lower risk and the risks among them easy to compare. There would be an opportunity for funds to re-examine how they conduct due diligence and consider new products that combine FSI with other risk/reward selection criteria. Perhaps we should look forward to funds, particularly international funds, that only invest in FSI-covered companies?

In some ways, the critics are right. FSI as proposed for the US is not suited to the UK. However, if capital markets professionals or exchanges or auditors can enlist insurers to provide FSI cover they may well gain competitive advantage. It would be fascinating to see a financial services innovation proposed in the US taken up first, with appropriate modifications, in the UK. Even more fascinating would be to watch an initiative bogged down in the US regulatory quagmire provide competitive advantage in the UK.

Do you agree that FSI is the best way forward? To take part in our online poll visit *Financial World* online at www.myifsllearning.com