Chapter 3
Post-Enron Reform: Financial Statement Insurance, and GAAP Re-Visited

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Abstract The fact that auditors are paid by the companies they audit creates an inherent conflict of interest that is endemic to the relation between the firm (the principal) and the auditor (the agent). I analyze a financial statement insurance mechanism that eliminates the conflict of interest auditors face and properly aligns their incentives with those of shareholders thus mitigating market inefficiencies arising from uncertainty regarding the quality of financial statements. 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 financial reports. The insurance coverage that the companies are able to obtain is publicized, as are the premiums paid for that coverage. The insurance carriers would then appoint and pay the auditors who attest to the accuracy of the financial statements of the prospective insurance clients. Firms 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 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.

3.1 Introduction

On October 16, 2001, Enron Corp. announced that it was reducing its after-tax net income by $544 million and its stockholders' equity by $1.2 billion. Because of accounting errors, Enron announced on November 8 that it was restating its

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previously reported net income for the years 1997–2000. The result of this restatement was a reduction in stockholders' equity of $508 million. Within a month equity was lower by $1.7 billion (18 % of the 9.6 billion previously reported on September 30, 2001). On December 2, 2001, Enron filed for bankruptcy under Chap. 11 of the United States Bankruptcy Code. 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 fifty-a- year in the early 1990s to well over two-hundred-a-year now. What happened?[1]

Can the roots of the calamities be traced back to Federal Reserve Chairman Alan Greenspan's famous 1996 warning of investors' "irrational exuberance"?[2] Are they a manifestation of the "infectious greed [that] seemed to grip much of our business community,"[3] which, on July 16, 2002, Greenspan impugned as responsible for the stock market's woes? Is it the foolishness of investors, coupled with the bursting of the stock market's bubble; or the depleted morality of the Chief Executive Officers (CEOs)? Is it the tendency to "cook" the books? Perhaps the collapse could be ascribed to the failure of the "gatekeepers": the auditing profession, or rather the industry it has become, boards of directors, audit committees, and the regulators. If the watchdogs misbehaved, is it because of moral turpitude or perverse incentives? And are the bright line financial reporting standards perchance the other culprits, encouraging designs to circumvent them and making it easier for auditors to acquiesce in some accounting and disclosure playfulness?

Sifting through all these causes can be a nightmare to any diagnostician. It may be tempting to suggest that all have contributed to the situation in varying degrees, but such a sweeping conclusion offers no constructive policy remedies. Effective crisis resolution requires sharp distinctions: which of the implicated circumstances are truly harmful, and which are benign, possibly even salubrious when considered in isolation? Among the potentially baneful conditions, which can be cured by reform and which are resistant to legislative or regulatory intervention? Finally,

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[1] This Chapter includes a reprinted article first published under the title "Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited" in the Stanford Journal of Law, Business and Finance in 2002, which is followed by the author's comments by way of a post script on further developments on the Financial statement insurance based on the original paper presented at the Third International Workshop on Accounting and Regulation in 2004.

[2] Greenspan (1996), The Challenge of Central Banking in a Democratic Society, Address at the Annual Dinner and Francis Boyer Lecture of The American Enterprise Institute for Public Policy Research (Dec. 5, 1996).

[3] Federal Reserve Board's Semiannual Monetary Policy Report to the Congress Before the US S. Comm. on Banking, Housing., and Urban Affairs, 107th Cong. (2002) (statement of Alan Greenspan, Chairman, Federal Reserve), available at http://www.federalreserve.gov/boarddocs/hh/2002/july/testimony.htm.

considering those ills that are susceptible to effective treatment, who would be the savior, government or the free market?

Not all remedies are equally effective. For example, although we all may be enraged that certain individuals and companies violated our trust, prosecution, and ultimate punishment may not adequately deter wrongdoing: intentional misrepresentation is difficult to discover or prove. Overhauling the regulatory structure and adding layers of supervision and monitoring by the government would be at best inefficient and socially wasteful. After all, the SEC already had vast authority to monitor and punish.[4] It is indisputable that optimistic investors and a depleted reservoir of ethics contributed to disaster.

But little can be done in the short run to fill the ethics reservoir, nor is it necessarily desirable to curb investors' enthusiasm. Rather, the solution lies in a market mechanism that realigns the incentives of the players of this economically vital financial game: let honesty be pursued in the self-interest of CEOs, Chief Financial Officers (CFOs), boards of directors, and the auditors; and eliminate the perverse incentives that are pervasive under the current social arrangement. Below I focus on financial statement insurance as such a market mechanism. I contend that it holds the promise of improved alignment of incentives, and hence better quality audits, more transparent and truthful financial statements, fewer shareholders' losses, more accurate pricing of securities, and, finally, more efficient resource allocation. This solution can be complemented and reinforced by a General Accepted Accounting Principles (GAAP) reform that redefines what components in the financial statements should be subjected to audit. Specifically, financial statement elements that inherently are not verifiable should not be audited; they are simply not auditable. They should be presented separately from the verifiable–the audited. Although these two remedies are mutually reinforcing, they can be implemented independently: each contributes.

Before I address financial statement insurance and the proposed GAAP changes, I present arguments that suggest that the critical—albeit not the sole—cause of the recent debacles was misaligned incentives of the auditors. In particular, a coincidence of circumstances, not all harmful by themselves, created an environment within which the misaligned incentives of the auditors brought about a failure in the gate-keeping function. Thus, the main conclusions I draw are the following:

- "Irrational exuberance" or the stock market bubble was not the source of the problem; rather, it magnified the payoffs for unethical conduct;
- Greed is harmless unless it is manifested in unethical actions;

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4 The SEC has the authority to establish generally accepted accounting and auditing standards, to review the financial statements registered with the SEC by most publicly traded corporations, to discipline CPAs who sign such statements (by rejecting statements they sign or by suspending or barring the CPAs from SEC practice), and to conduct investigations and recommend possible criminal inquiries to the Department of Justice.

- Society is better off when its members are more ethical, but ethical profiles are difficult to change in the short term;
- Ethical conduct is responsive to incentives: rewards and punishments;
- Market incentives, if feasible, are more effective and less socially costly than those that are created by legislation or governmental regulation. At the very least, they complement the latter;
- Financial statement insurance constitutes one such market-mediated set of incentives;
- Separation between verifiable (to be audited) and unverifiable (not to be audited) elements of financial statements sharpens investors' awareness of risks and so improves resource allocation.

3.2 The Role of "Irrational Exuberance," "Infectious Greed," and the Stock Market Bubble

Three themes have dominated the media recently: "cooking" the books by corporate America, the "irrational exuberance" in the 1990s, and the "infectious greed" plaguing our society. The themes are closely related; exuberant investors, rushing to buy stock when earnings exceed expectations by as little as a penny, tempt greedy executives to "cook" the books. Was the exuberance "irrational"? Is the greed infectious and hence baneful? Were the books "cooked"?

Exuberance—the enthusiasm evinced in the bidding up of the prices of securities, especially those of high technology firms—is embedded in beliefs about the firms' prospects. Even if optimism about the new technologies of the 1990s permeated the markets, there is nothing "irrational" about beliefs that, even with initial losses, entrepreneurial firms will do well in the future. Besides, early investors in successful new technologies earn a greater than normal return on their investment. Beyond that is the increase in the "winner's" social standing for having been a seer; throughout history people have venerated prophets. An examination of this proposition historically will disclose that it was true in many situations: from railroads to automobiles, airplanes, electronics, computer hardware, and software. It is also true that there are many examples where highly touted new technologies did not pay off. Consider, for example, cold fusion and wind and solar energy. Yet the ultimate failure of a venture does not imply that the prior beliefs that led investors to embark on it were "irrational," just as "rational" beliefs do not guarantee ultimate success. As to the state of optimism, no judgment can be rendered on its rationality: it reflects a subjective model of where the economy is headed, formed by each individual's scanning of the surrounding environment. It could be seen just as rational in the 1990s as pessimism is today.

What about greed? The American Heritage Dictionary of the English Language, defines it as "an excessive desire to acquire or possess more than what one needs or deserves, especially with respect to material wealth."[5]

Under our capitalist system, need is not the criterion for allocating material wealth. Instead, the claim for the allotment of wealth is the marginal contribution to the economy, i.e., what one deserves. But our highly competitive economic system will not allow the misappropriation of wealth by the undeserving, unless the undeserving has misrepresented—"cooked" the books. Before we turn to this "cooking" theme, however, note that if deserving, the "desire to acquire or possess" is no longer "excessive," nor are the desirous "greedy." They would be the ambitious entrepreneurs who fuel our economic engine. The more infectious their ambition, the faster the engine will accelerate.

Did corporate America "cook" the books? Some—the less ethically endowed—probably did. Most others, using their discretion under GAAP to choose from a range of resulting earnings numbers, must have signaled their genuine optimism regarding the future; hence the rosy numbers that now seem unsustainable. Indeed, many of the accounting numbers reported in financial statements reflect largely nonverifiable expectations. Giving credence to them requires the same degree of optimism on the part of investors. Thus, the so-called "bubble" of the 1990s may well have resulted from a sanguine vision of the future—shared by both executives and investors.

The bubble and its bursting are a reflection of the cycle of optimism giving way to pessimism. Neither can be asserted to be irrational. The more pointed question—whether we are better off without booms and busts—has no easy answers. It is likely the bubbles are the agent of technological "creative destruction" that promises the forward leaps beyond. An economy without optimism is a stagnant economy. On balance, therefore, I conclude that exuberance, greed, and bubbles are not necessarily the axis of evil that Federal Reserve Chairman Alan Greenspan makes them appear to be. What transforms ambition into the infectious greed that Greenspan deplores are the incentives to "cook" the books, which are made all the more potent by the allure of profits that the stock market bubble and investors' exuberance make possible. Because auditors have been tempted to wink at, or even encourage, accounting gimmicks such as the creation of Special Purpose Entities (SPEs), allowing Enron to hide debt and losses, or the possibly improper recording of swap transactions among telecommunication companies, the Enron affair became possible, and the Tyco and WorldCom scandals that followed. But what made the auditors wink? And what made CEOs and CFOs so desirous of that wink? Clearly the paucity of ethical standards and values contributes, but so do the

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[5] American Heritage Dictionary of the English Language (4th ed. 2002), *available at* http://education.yahoo.com/reference/dictionary/index.html.

perverse incentives driving the actions of these players. I turn next to a discussion of the roles played by ethics and incentives. This discussion will convince the reader, I hope, first, that at least in the short term, incentives are required to elicit ethical conduct, and, second, that market incentives are necessary beyond legislative and/or regulatory reform.

3.3 The Importance of Ethics for the Accounting Profession

Ethical behavior is vitally important to businesses, but it plays a far more critical role in the attestation of auditors to financial statements. Ethical behavior is a necessary condition for investors to benefit from the auditors' product—the credibility of the auditors' attestation to financial statements. Society can consume the output of goods provided by businesses (such as automobiles, tobacco, perfumes, etc.,) managed by unethical individuals, although this may not be true to the same extent in the case of "modern economy" businesses that supply knowledge products. Yet society cannot rely on the financial reports of these businesses if it perceives a possibility of misrepresentation. Thus, society would not be able to use auditors' attestation services without perceiving the auditors to be ethical. Hence, in addition to the skill and competence required to detect misrepresentations or omissions in financial statements, for auditors it is of equal or even greater importance to possess the ethical trait of rendering an honest opinion.

Indeed, the importance of ethical conduct to accountants cannot be overstated. It has always been recognized that accounting was a special profession as far as public interest was concerned. Nowhere has this point been made as sharply as by former "Chief Justice Warren Burger", making the distinction between lawyers and accountants.

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.[6]

In the following sections, I elaborate on how the demand for ethical auditors is derived from the demand for truthful financial statements.

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[6] United States v. Arthur Young & Co., 465 U.S. 805, 817–18 (1984).

3.3.1 Ethics as an Economic Good

From an economic standpoint, I define unethical behavior as purely self-interested behavior that inflicts harm on others. It characterizes a self- interested individual who prefers a course of action associated with some benefit while the damage caused to others is large.[7] The standard economic model for the rational agent is that of a purely self-interested individual. Within a business, the objective of stockholders is to maximize value. Accounting can be viewed as part of the necessary self-controls instituted by representatives of stockholders (boards of directors, BODs)—assuming BODs' interests are aligned with shareholders' interests—to bound the feasible actions that managers and employees can take. The cost-benefit trade-off involves balancing the increased cost of more elaborate accounting and internal controls against the benefits of more efficiently directed self-interested behavior.

First, suppose ideally that investors directly observe the degree to which managers (agents) engage in ethical behavior, and, furthermore, that all relevant parties' interests are perfectly aligned. What quantum of ethics can we expect to be exhibited in such a utopian world? Agents likely exhibit varying degrees of ethical behavior. The more unethical would covet consumption at the expense of others to a larger degree than the relatively more ethical. Under the preferable social arrangement, wherein incentives are perfectly aligned, it should be in the self-interest of corporations to elevate ethical standards governing the behavior of their officers and employees. Thus, suppose the BOD believes management and other employees rank low on the ethical scale. It would then direct the investment of some corporate resources in improving the internal control and audit systems to avert the higher potential costs of fraud, chicanery, embezzlement, and other detrimental (to itself) self-interested behavior on the part of its officers and employees. High ethical standards would result in net savings to the corporation, which would require less internal control and audit services. If more managers of corporations are known to be ethical, auditors would need to invest less effort, reducing audit fees and the total social cost of ensuring such credibility of financial statements as would allow proper functioning of the capital markets. Were the market to realize that a given corporation has become more ethical, such as by ridding itself of the unethical and hiring the ethical, the value of the corporation would increase by the amount of anticipated savings in the consumption of control and audit services. In this sense, accounting controls and ethical conduct can be viewed as economic substitutes.

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[7] *See* Koford and Penno (1992), *Accounting, Principal-Agent Theory, and Self-Interested Behavior*, *in* Ethics and Agency Theory 127 (N. E. Bowie et al. eds., 1992). This is the definition of unethical behavior generally articulated or implied in the economic literature.

3.3.2 External Audits as Substitutes for Unobserved Ethical Endowments

Unfortunately, investors cannot directly observe the degree to which managers' actions are ethical. Managers with high ethical standards wish to advertise their "righteousness" to enhance the value of their shares. Yet nothing prevents managers with low ethical standards from engaging in false advertising. To guarantee to potential purchasers the truth of their advertisement, high-quality managers will hire auditors to attest to the veracity of the disclosures: the auditors will opine that there are no material misrepresentations in the client's financial statements (the advertisements). Just as substitution between ethics and accounting and auditing controls occurs within the organization, a similar substitution will be manifested externally: organizations with a higher concentration of unethical agents will require a greater investment of external audit resources.

For their attestation to be credible, the auditors must be perceived as "objective" and "neutral" qualified outsiders. They need to exert effort in detecting potential misrepresentation and to convince investors that they have done so. Potential penalties must face auditors who do not conduct their job appropriately. Without such penalties, auditors' pursuit of their own self- interest may induce them to collaborate with the "poor quality" managers, diminishing the credibility of the financial reports. Presumably, in attempting to minimize such penalties, the auditors will have an incentive to apply such audit procedures as will enable them to detect biases in management's representations. SEC enforcement actions and suits, and civil suits brought by stockholders, have constituted these penalties. The Sarbanes–Oxley Act of 2002 (the Act), imposes harsher penalties on directors and officers and restrictions on auditors' services.[8]

So far, however, the existing deterrents have proved to be ineffective in curbing abuses. One needs only to scan the headlines announcing one accounting irregularity after another to entertain no doubts about the failure of the current system. Furthermore, there is no reason to hope the increased potential fines and imprisonment terms introduced by the Act will make any more than a marginal dent in the tendency to "cook the books" over the long haul. Why?

[8] Sarbanes–Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002). The Act prohibits auditors from providing most of the traditional nonaudit services, such as bookkeeping, financial information systems design, appraisal services, fairness opinions, actuarial services, internal audit services, management functions, investment banking, legal and other expert services unrelated to the audit, and any other services deemed by the Public Company Accounting Oversight Board to be impermissible. *Id*. (§ 201). The Act also requires that all services (with some minor exceptions) be preapproved by the audit committee and that such pre- approvals be disclosed in public reports. *Id*. (§ 201–202).

3.3.3 The Perverse Incentives of Auditors

The problem is that the incentives driving auditors' behavior are not properly fine-tuned to elicit unbiased reports. In the current social arrangement, auditors operate under perverse incentives: they are paid by the companies they audit and hence they are beholden to the CEOs and CFOs who ultimately decide on the hiring of their services. While, theoretically, auditors are supposed to be the agents of the shareholders, in practice it is management that engages the auditor. Shareholders admittedly vote on management's recommendation of which auditor's services to hire, but the decision is effectively handed over to management: widely dispersed share ownership and the mechanism of proxy voting result in many shareholders giving their proxy votes to management, and others refrain from voting altogether.

This arrangement creates an inherent conflict of interest that is endemic to the relation between the client (the principal) and the auditor (the agent). The client-principal (management) who engages the auditor ultimately pays for the services and hence de facto structures the compensation of the auditor- agent to elicit such actions (opinions) of the auditor as would best serve his own interests. The fear of losing an indefinite stream of future audit fees—even without the added allure of nonaudit services now mostly barred by the Act—effectively guarantees that the auditor complies with management's wishes.

The threat of legal liability is not sufficiently fine-tuned to balance the incentive of doing management's bidding.

Moreover, the expected cost of litigation and other penalties is recouped on the average from the auditees, albeit in an economically distorted fashion: the auditor does not recoup his expected litigation costs from each client in proportion to the latter's contribution to the risk of the auditor being litigated against or fined and to the consequent damages the auditor suffers. In other words, the recoupment from any client is not commensurate with the damages the particular client causes. This results in an inefficient allocation of risk and resources.

Furthermore, the recoupment is made out of the client-corporation's resources, thus diminishing the wealth of shareholders who purchased the shares at prices potentially inflated as a result of misrepresentations. Consider the irony: instead of the shareholders being protected, they end up partially shouldering the cost and burden of perpetuating the cozy cohabitation of auditor and management. Some, perhaps plaintiffs' attorneys, may argue that the liability exposure of the auditors is not high enough and that it should be increased sufficiently to deter malpractice. Yet in addition to failing to address the misallocation of risk and resources, increasing exposure to liability and instituting draconian penalties may drive auditors out of the business of auditing—certainly not a welcome prospect.

I conclude that no exogenous force—legislation, regulation, enforcement, or litigation—can satisfactorily resolve the intractable conflict of interest. I would argue that only severing the agency relation between the client-management and the auditor can remove the inherent conflict of interest. We need to create instead an agency relationship between the auditor and an appropriate principal–one whose economic interests are aligned with those of investors, who are the ultimate intended beneficiaries of the auditor's attestation. Such a realignment of interests would restore the "complete fidelity to the public's trust" that Chief Justice Burger insisted on in his opinion cited above.[9]

Who, in the context of a free market mechanism, can serve the role of such a principal? I maintain that the insurance carriers are an eminently reasonable candidate. The scheme I am proposing is Financial Statement Insurance. To this I turn next.

3.4 Financial Statement Insurance

Financial Statement Insurance (FSI) would make for a significant change in the principal-agent relationship. 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.[10] Below I sketch the major elements of the FSI mechanism.[11]

[9] *See supra* note 5 and accompanying text.

[10] Sir Thomas Gresham was a financier born in London, England in 1519. Knighted in 1559, he was for a time the English ambassador at Brussels. "Gresham's Law" is an economic observation attributed to him: if there are two coins of equal legal exchange value, and one is suspected to be of lower intrinsic value, the "bad" coin will tend to drive the other out of circulation, as people will hoard the "good" coin. *See* Webster's World Encyclopedia: The Cambridge Biographical Encyclopedia (Webster's Millennium 2002 CD-ROM, 2002).

[11] For further background information on the FSI mechanism, see Ronen and Cherny (2002) *Is Insurance a Solution to the Auditing Dilemma?*, Nat'l Underwriter, Life and Health/Fin. Services Edition, Aug. 12, 2002, at 26.

3.4.1 The FSI Procedure

The FSI underwriting procedure starts with a review of the potential insured. The review is performed, on behalf of the FSI carrier, by an expert risk assessor, who investigates the nature of conditions such as the following:

- The nature, stability, degree of competition, and general economic health of the industries in which the potential insured operates;
- The reputation, integrity, operating philosophy, financial state, and prior operating results of the potential insured's management;
- The nature, age, size, and operating structure of the potential insured;
- The potential insured's control environment and significant management and accounting policies, practices, and methods;
- The FSI process might proceed as follows (see Fig. 3.1):

Step 1: The potential insured requests an insurance proposal from the FSI carrier. The proposal contains, at a minimum, the maximum amount of insurance being offered and the related premium. Typically, it also specifies a schedule of amounts of coverage below the maximum along with associated premiums. The proposal request is made prior to the preparation of the potential insured's shareholders' proxy on the basis of the underwriting review described above. The reviewer can be the same auditor who will eventually audit the financial statements.

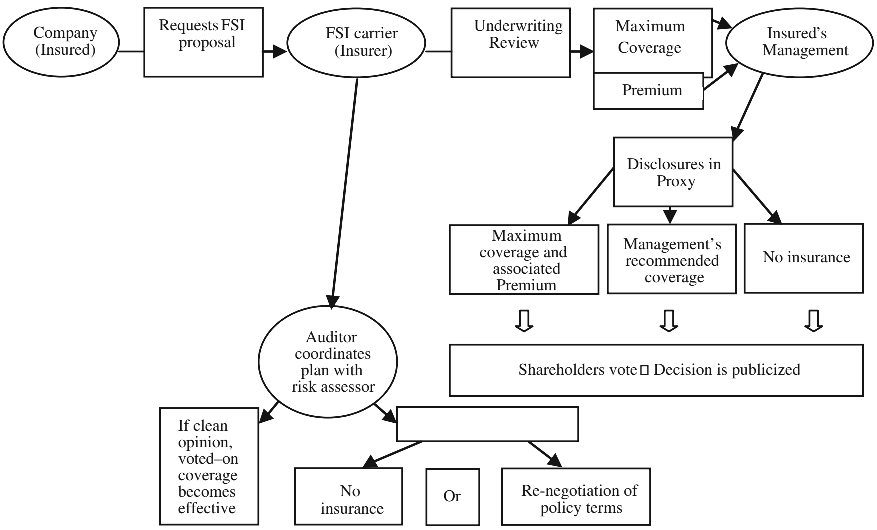

Fig. 3.1 The FSI process

Step 2: The proxy offers the following alternatives. The maximum amount of insurance and related premium as offered in the insurance proposal. The amount of insurance and related premium recommended by management. No insurance.

Step 3: If either of the insurance options set forth in Step 2 is approved, then the reviewer and the auditor cooperatively plan the scope and depth of the audit to be conducted.

Step 4: If, after the audit, the auditor is in the position of rendering a clean opinion, the policy is issued. That is, the originally proposed coverage and premium will be binding on the insurance carrier if the auditor's opinion turns out to be clean. If the auditor's opinion is qualified the insurer will not provide any coverage unless the company can then renegotiate different terms with the insurer, which would depend on the auditor's findings and reasons for qualification. To the extent the policy terms are renegotiated, the new agreed-upon terms would be publicized.

Step 5: The auditor's opinion will contain a paragraph disclosing the amount of insurance that covers the accompanying financial statements and the associated premium. The FSI concept also contemplates an expeditious claims settlement process. The FSI carrier and the potential insured cooperatively select a fiduciary organization whose responsibility is to represent the financial statement users when a claim is made. Part of the fiduciary's responsibility is the assessment of claims before notifying the FSI carrier.

After the fiduciary notifies the FSI carrier of a claim, the FSI carrier and fiduciary mutually select an independent expert to render a report as to whether there was an omission or misrepresentation and whether it did give rise to the amount of losses that resulted. Within a short time after receiving the expert's report, the FSI carrier compensates the fiduciary up to the face amount of the policy for the damages.

In what follows, I describe in more detail how the FSI scheme plays out in the decision-making process of each of its participants: the insurer, the auditor, the capital market, and the insured. Figure 3.2 depicts stylistically the relations among the parties.

3.4.1.1 The Insurer

First, consider the insurance carrier. Having extended coverage at a certain premium,[12] the objective of the insurance carrier would be to minimize its claim losses. Accomplishing this objective is tantamount to minimizing shareholder losses. Hence, the interest of the insurance carrier is aligned with the interests of shareholders. By aligning the interest of the auditors with the interest of the

[12] How the premium is determined is discussed in the proceeding paragraph.

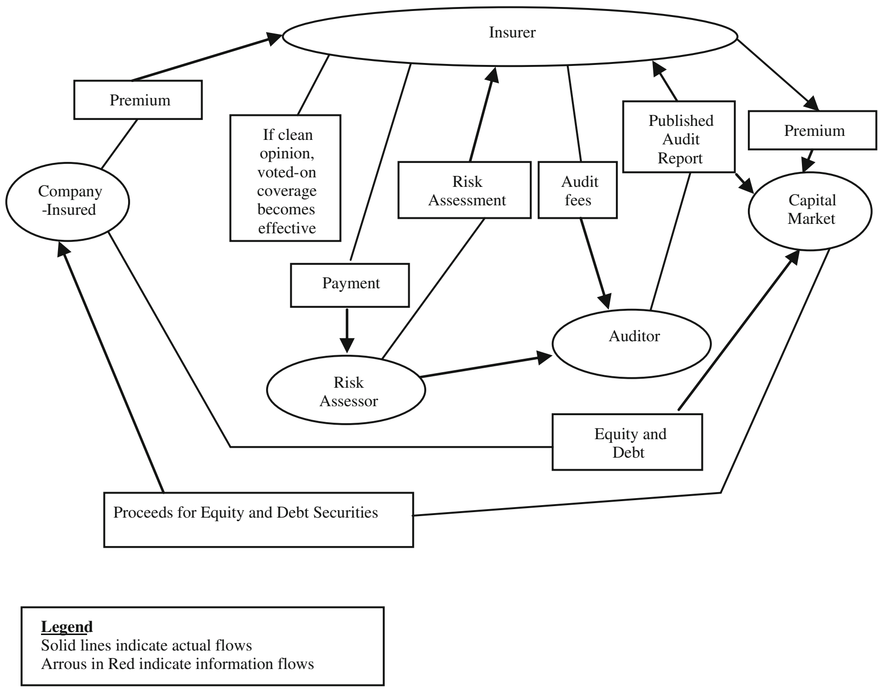

Fig. 3.2 Relationships among the parties

insurance carrier who hires the auditor's services, we are able to align the interest of the auditors, by extension, with the interests of shareholders.

Now I turn to the process by which the magnitude of the premium is determined. The insurer is subject to the checks and balances of the market. This market tension ensures that the premium is determined in as accurate a fashion as possible. The first market force is one that pressures the insurer to assess as low a premium as possible. This is the force of competition. Because the insurance industry is competitive, to ensure maintaining or expanding market share any insurer would wish to minimize the premium for a given amount of coverage he extends to the insured. On the other hand, the opposing market force induces the insurance carrier to charge a premium that is sufficient to cover the expected claim costs and other expenses, including the industry-wide profit designed to compensate for the entrepreneurial and managerial services the insurers provide. If the premium is not high enough, the insurer would not be able to survive.

Some may argue that short-horizon insurers may low ball—charge too low a premium relative to the risk undertaken by extending the coverage to gain market share—and skim the market. Yet if that is likely to happen under my proposed regime, it is equally likely to happen under the existing regime, in which the insurers provide directors and officers insurance that includes coverage for the corporations as well. In other words, the proposed regime would not introduce perverse incentives for insurance carriers beyond what they face today. Put differently, my proposal would align auditors' incentives, hence yielding benefits even if it did not cure other perverse incentives that guide the myopic insurers. In any case, the cure for myopic insurance executives lies elsewhere: in reforming the corporate governance in the insurance industry, in properly designed compensation schemes, and in regulatory supervision. As it is, the insurance industry is one of the most regulated in our economy. This regulatory monitoring will continue under the proposed regime. In fact, one of the benefits of the proposed regime is its reliance on the already existing extensive regulation in the insurance industry, thus obviating the need for another layer of regulation in the auditing arena.

The opposing market forces, the competitive pressures to minimize the premiums charged, and the survival-induced motivation not to charge too low a premium, ensure that the insurance carrier would strive to compute as accurate a premium as possible to effectively compete with rivals. This impulse would drive the insurer to design an optimal incentive scheme that motivates the external auditor or risk assessor he hires to exert optimal efforts in conducting the review or the audit: to adopt the perspective of his principal—the insurer—and hence conduct the review or the audit with diligence and with the aim of ensuring the absence of omissions or misrepresentations. After all, such misrepresentations are the source of potential loss to the auditor's or the assessor's principal, the insurer, which the auditor or assessor would be motivated to minimize.

Can the insurer bear the claim losses if the coverage demanded by the insured and supplied by the insurer is very large? There are two answers to this question. First, suppose we fix coverage under the proposed regime at the same level investors recover under the current regime. This means that, in equilibrium, the premiums paid under the proposed regime would at most equal the total cost to corporations of directors' and officers' insurance, audit fees, and the additional litigation settlement costs they incur as a result of class-action suits filed against them.[13] Under this condition, the coverage would be affordable—it is the same as under the current regime. The auditors' incentives, however, would be better aligned with those of shareholders, thus eliminating the conflict of interest and improving audit quality. That is, other things being equal, the proposed regime would be superior at least from the standpoint of improved audits.

Now suppose we relax this hypothetical ceteris paribus condition and allow for the possibility that the coverage extended under the proposed regime would exceed the insurance coverage under the current regime. Will the insurance industry have the capacity to pay? The answer to this question is yes because, unlike property and casualty insurance for example, the losses insured against—decreases in the valuation of companies resulting from omissions or misrepresentations in the financial statements—can be hedged in the capital markets with properly

[13] Below I shall argue that for the same coverage the equilibrium magnitude of the premiums paid under my proposed regime would be less than under the existing regime because of the improved audit quality, improved financial statement quality, and hence smaller shareholder losses.

constructed derivatives, the exercise of which can be made contingent on the same triggering events that cause loss to shareholders, i.e., the financial statement and audit failures that are manifested in omissions or misrepresentations. Specifically, the insurer can buy a special put option with a duration that corresponds to the period covered under the policy.[14] The put would be exercisable upon a stock price decline of the insured that was determined to have resulted from misrepresentations or omissions in the insured's financial statements. Investment funds (pension funds, mutual funds, and the like) would be willing to sell these puts for less than the price of general puts (that are not conditional on misrepresentations) and would thus enable the insurer to reinsure whichever portion of the coverage he wishes not to retain at an affordable cost. The put sellers can minimize their exposure on these written puts by constructing portfolios that are well diversified with respect to the risk of misrepresentations and omissions. The assessment of such risks can be provided by independent rating organizations akin to bond rating agencies, such as Standard & Poor's Corp.

The incentive to assess accurate premiums creates the insurers' demand for review and risk assessment services. These can be, but need not be, conducted by the same auditor who ultimately opines on the financial statements. At the same time, having determined the premium, the incentive not to extend the contemplated coverage upon the discovery of large risks creates a demand for the familiar external audit. This audit, which would be of higher quality than under the current regime, will ultimately determine whether the insurer agrees to extend the coverage. If the opinion is clean, the coverage becomes effective. If the opinion is qualified for a variety of reasons, either the coverage is withdrawn, or the insurer renegotiates a different coverage and premium, the magnitudes of which would depend on the reasons for the qualification. Thus, two layers of monitoring protect the insurer: the initial risk review and assessment that helps determine the tentative coverage to be extended and the associated premium, and the external audit that finally determines whether the tentative agreement (policy) would become effective. The sequence of activities is necessitated by (1) the need to contract at the beginning of the fiscal year (or the end of the prior fiscal year) on coverage and the premium so that these can be publicized and made available for the capital markets to assess the quality of the financial statements and to accurately price the securities (as a result of making portfolio decisions) and (2) the subsequent need to conduct the external audit, geared toward assuring the absence of material loss-causing misrepresentations. The plan for the external audit would be prepared in consultation with the insurer—the principal—and the risk assessor who conducted the initial review so that the details of the plan would be tailored to the findings of the initial risk review. Such a coordinated audit plan would de-emphasize the mechanical sample testing of journal postings and emphasize the more costly but more meaningful verification of assets and revenues.

[14] A put option is a contract giving its owner the right to sell a fixed number of shares of a specified common stock at a fixed price at any time on or before a given date.

3.4.1.2 The Auditor

In the current social arrangement, the auditor's perspective is not aligned with that of shareholders, but rather mirrors the perspective of his clients—effectively management. The auditor finds it difficult to deviate from the client's perspective because of the inherent non-verifiability of many elements of the financial statements. Management generates the data and prepares the financial statements, which it then presents to the auditor. The auditor tests for accuracy and evaluates the statements for compliance with GAAP. In most of the recent revelations regarding accounting irregularities, it seems that the issue was not the accuracy of the underlying data, but the way the data were classified and presented in the financial statements; as examples, consider liabilities that are recorded as revenues or expenses that are recorded as assets. In many cases, while the data available are accurate, projections based on these data cannot be verified by the auditor. Consequently, he would have insufficient grounds to dispute the subjective valuations made by the client.

Indeed, even though the financial statements are allegedly based primarily on historical transactions, most of these past events play themselves out in the future. The cash flow expected to be generated must be predicted. In many of these instances, such as the valuation of residual interests in securitized financial assets, the estimation of these future cash flows is largely subjective, resulting in wide ranges of numbers that can be quantified as assets on the balance sheet. The evaluation of such forward-looking events requires the examination of assumptions that are based either on past experience or on models that forecast the probability of given outcomes. In stable environments, these models can yield relatively objective numbers. In volatile environments, however, they can result in misleading numbers. In the latter case, the ability of the auditor to verify the numbers is significantly impeded. In the current regime, managers would argue the validity of the assumptions until proven wrong. The auditor's incentives, influenced by the fear of loss of an indefinite stream of future audit fee revenues from the client he audits, would almost assuredly cause the auditor to give the client the benefit of the doubt.

By contrast, under the proposed regime, because of the incentive structure that realigns the auditor's interest with the insurer's, the auditor would be predisposed to insist on a greater degree of verifiability before acquiescing in management's valuations. The auditor would be identifying with the persons or entities that would suffer a loss in the event of a misrepresentation or omission in the financial statements. Although this greater insistence on verifiability may cause management to be less willing to undertake ventures that perforce require the evaluation of forward-looking consequences of transactions and hence to exhibit greater risk aversion, this may not be a bad outcome from a societal point of view. The system should overall result in a better balance between risk-taking and the needs of financial statement users. Companies would attempt to balance their quest for higher returns against the avoidance of being penalized by the capital markets for unreliable numbers in the financial statements presented.

Under the proposed regime, the auditor would choose the audit quality so as to maximize his expected compensation.[15] Because the compensation scheme is designed by the insurance carrier, the auditor would decide on the quality that is optimal from the standpoint of the insurer, and hence the shareholders. Specifically, the auditor would attempt to maximize the difference between the audit fee revenue he expects from the insurer and the expected costs of misrepresentations and omissions. This attempted maximization would induce him to choose the optimal audit quality. The insurer has at its disposal potent penalties to deter the auditor from deviating from the desired quality. Unlike the current regime, in which a bad audit may cause a loss of the client's engagement and some expected litigation costs, under the proposed regime the auditor faces two kinds of penalties that an audit failure can trigger. The first is his tort liability pursuant to the contractual relationship between him and the insurance carrier. The second is the threat of losing the possibly very many clients the insurer has assigned him to audit. Note the change in the market structure: under the current regime the auditor–client relationship is one-to-one; under the proposed regime the relationship is one to many: the auditor and many auditees assigned by the insurer. The threat of losing many auditees' engagements upon an audit failure that is related to only one of these auditees is a very potent penalty.

3.4.1.3 The Market

For the purpose of this discussion, I assume that the stock market is semi-strong efficient; publicly available information is unbiasedly and quickly impounded in the market prices of stocks.[16] Hence, the publicized coverage that the shareholders of the insured approved and the premium paid to obtain that coverage would provide a credible signal to the marketplace regarding the underlying quality of the financial statements, i.e., the degree to which they may include omissions or misrepresentations. The FSI mechanism would satisfy the conditions required for a signaling equilibrium.[17] The larger the coverage the insured purchases, the larger the premium the company must pay; but for any given coverage, the better the quality of the financial statements, the smaller the premium the insurer will assess. The more effective the internal accounting and auditing controls and the corporate governance system in place, the more likely the risk assessor hired by the insurer will assess lower risk, in turn resulting in the insurer's assessing a lower premium. The better the quality of the review and risk assessment process, the more accurate

[15] What I mean by quality in this context is the combination of effort that the auditor exerts on the job and the level of his objectivity and freedom from bias.

[16] Consider, however, the so-called "anomalies," such as the post-announcement drift, that can be explained within a rational market, as shown by in A. Dontoh et al., *On the Rationality of Post-announcement Drift*, 8 J. Acct.. Stud. 69–104, 2003.

[17] *See generally* Riley (1979), *Informational Equilibrium*, 47 Econometrica 331, 333–36 (1979) (discussing the relevant conditions).

the premium assessment. Thus, the better the quality of the financial statements, the lower the cost borne by the insured for a given coverage. Equivalently, for a fixed premium, insureds with better quality financial statements will be able to purchase more coverage. This means that the conditions for a signaling equilibrium would be satisfied under the financial statement insurance mechanism (some additional technical conditions would be easy to satisfy as well), so the publicized pair of signals, the coverage and the premium (along with disclosures of significant terms of the insurance policy), would be a credible signal to the markets regarding the underlying quality of the insured's financial statements. The market would be able to compare different companies and reckon which presents more reliable financial reports. Given the semi-strong efficiency of the market, these different qualities would be priced into the securities offered by the insureds to the public or traded in the secondary markets.

But this is not the whole story. Consider the policy coverage. Since the FSI procedure requires that the coverage be approved by the shareholders, and since the coverage is common knowledge, in that it is publicized both in the proxy and in all financial reports issued by the insured, the market is made aware of the coverage, and having priced it into securities, an implicit contractual agreement would have been formed. The market would come to understand the limit to which it is to be indemnified in the case of loss. Although a plaintiff class may still be able to sue for damages beyond the limits of the policy, it seems less likely that it would prevail: the investors were put on notice regarding the limit of the policy coverage and will have paid less for the security with the lower coverage and thus protected themselves in advance against the risk of misrepresentations. This would have the effect of practically limiting the exposure to the policy coverage and hence decreasing the dead weight loss to society caused by lengthy litigation.

The implication of the pricing of the financial statements' quality is that the traded securities would be more complex instruments than the ones we have under the current regime. The securities would reflect two additional dimensions: the coverage shareholders can claim upon the triggering event of misrepresentation or omission, and the underlying reliability of the financial statements, as reflected in the premium for the given coverage. This more accurate pricing of the securities would provide more precise signals to institutional and individual investors to help them better channel their savings and capital to worthy projects. Companies undertaking more promising ventures would be able more reliably and credibly to transmit information about the potential of these ventures to the markets, and hence to obtain funds to finance them more cheaply and easily. Resources would be allocated more efficiently; social investment would yield a higher return.

3.4.1.4 The Company—the Insured

Now we come full circle back to the company purchasing the insurance. Under the proposed regime, a company with better quality financial statements would have an incentive to signal its superiority to the marketplace by demonstrating that it can obtain higher coverage at a lower premium relative to other companies in its industry. It would do so because it reckons that the coverage it obtains and the premium it pays would be made public, and, furthermore, would be viewed by the market as credible signals of the true quality of its financial statements. As a result, the company knows that its securities would be priced at a higher level, thus decreasing its cost of capital and increasing its ability to finance worthy projects. Companies with poorer quality financial statements would be forced to reveal the truly lower quality and reliability of the financial reports because they would not be able to obtain the same coverage as the better companies (companies with better quality financial statements) except by paying a higher premium; recall that the risk assessment conducted by the insurer's agent would have resulted in a higher premium, commensurate with the poorer quality the assessor would have discovered. Thus, the company with poorer quality financial statements would have no choice but to reveal the true state of its financial reports: either it is forced to pay the higher premium or it would decide not to purchase any insurance. Both occurrences will reveal the truth.

For the company with poorer quality financial statements, this is not a happy state of affairs. It cannot pretend that it is one of the better companies: the insurer would impose the necessary discipline by having the company's management and internal controls reviewed as a condition for extending the coverage and determining the premium. Moreover, the coverage would not be extended if the external auditor does not issue a clean opinion. Reckoning that if the coverage is not extended, a significant drop in the stock price would ensue, the company would refrain, ex ante, from attempting to emulate the better companies by purchasing high coverage that would likely not be extended were the external auditor to decline to issue a clean opinion. Of course, in addition, the potential emulator would have had to pay a higher premium at the outset because of the unfavorable findings by the risk assessor. What is such a company to do? It now would reckon that it is in its best interest to improve its internal accounting and auditing controls so as to qualify for the higher coverage and the lower premium. That is, it would now compete with the better companies by actually improving its systems so that the risk assessor would induce the insurer to assess a low premium, correctly signaling to the marketplace the improved quality of the insured. Formally, the company would choose the quality of its financial statements to maximize the difference between the proceeds of shares it issues and the premium it has to pay for the insurance, recognizing at the same time, that the premium would be set by the insurer so as to minimize its claim losses and that it would assess the premium conditional on the findings of the risk assessor it hires for the purpose and would extend the coverage conditional on the external auditor issuing a clean opinion.

3.4.2 Recapitulation

The FSI scheme effectively eliminates the conflict of interest so evident in the aftermath of Enron and its sequels. But as I have shown, financial statement insurance has other important benefits: the credible signaling of financial statement quality and the consequent improvement of such quality, the decrease in shareholder losses, and the better channeling of savings to worthy projects.

Are there additional remedies for what ails financial reporting today? In my introductory remarks to this essay, I alluded to the bright line financial reporting standards that some blame for the malaise. Below I argue that FSI, if implemented, would facilitate an accounting approach based on underlying principles rather than detailed rules. On the other hand, without the incentive alignment proffered by FSI, having underlying principles without detailed rules govern accounting practice can be hazardous to investors' financial health.

3.5 Principles and Rules

I now turn to the recent debate regarding rules and principles. It has been argued that the US model of specifying rules that must be applied has allowed or encouraged firms such as Andersen to accept procedures that, while conforming to the letter of the rules, violated the basic objectives of GAAP accounting. For example, while SPEs in Enron usually appeared to have the minimum required three percent of independent equity, Enron in fact bore most of the risk. The contention is that general principles such as UK GAAP that require auditors to report a "true and fair view" of an enterprise are preferable to the over-specified US model, and that the US model encourages corporate officers to view accounting rules as analogous to the Tax Code.[18] Indeed, the contrast drawn with UK GAAP has also caught the attention of the popular press. Consider, for example, the following quotation from a recent Wall Street Journal article: Sir David Tweedie, the retiring chairman of the International Accounting Standards Board, testifying before Congress on Feb. 14, explained, "Companies want detailed guidance because these details eliminate uncertainties about how transactions should be structured. Auditors want specificity because these specific requirements limit the number of difficult disputes with clients and may provide a defense in litigation. Securities regulators want detailed guidance because these details are thought to be easier to enforce."

While this rationale makes sense on one level, it fails on another. It engenders a mindset among accountants, auditors and managers to ask the wrong question: "Is it legal?" instead of "Is it right?" High-priced lawyers and skilled merchant bankers can often find a way through the thicket of regulations because human ingenuity is such that it is impossible to cover every possibility… The alternative to this rule-based approach is one pursued by IASB. In the words of Sir David: "Put simply, adding the detailed guidelines may obscure, rather than highlight, the

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[18] *See* Benston and Hartgraves (2002), *Enron: What Happened and What We Can Learn From It*, 21 J. Acct. and Pub. Pol'y 105, 126 (2002).

underlying principle. The emphasis tends to be on compliance with the letter of the rule rather than on the spirit of the accounting standard."

"Our approach," Sir David explains, by contrast, "requires both companies and their auditors to exercise professional judgment in the public interest. Our approach requires a strong commitment from preparers to financial statements that provide a faithful representation of all transactions and a strong commitment from auditors to resist client pressure. It will not work without those commitments."

Sir David's bottom line: "There will be more individual transactions and structures that are not explicitly addressed. We hope that a clear statement of the underlying principles will allow companies and auditors to deal with those situations without resorting to detailed rules."[19]

I served as associate director of research at the AICPA-appointed "Trueblood Objectives Group," which issued a report on the objectives of financial statements.[20] This report, along with a companion volume of selected papers,[21] was the precursor for the Conceptual Framework that guides the Financial Accounting Standards Board (FASB)'s setting of detailed standards. At the time, some of the committee's members viewed the objectives that later became the "Conceptual Framework" as a sort of a constitution to guide the promulgation of standards, just as the United States Constitution governs the legislation of statutes and the case law. I interpret the recent clamor for principles and against rules as an appeal to make do with the Conceptual Framework without the detailed standards issued by the FASB. In other words, let the Conceptual Framework alone govern practice—the guidelines it offers should suffice for the accountants to report a "true and fair view." Yet, without FSI, auditors' incentives are not aligned with shareholders, and although the Conceptual Framework formulates desirable objectives of financial reporting, it leaves ample room for corporate managers to misrepresent unless potent incentives are in place that motivate telling the truth.

It may be useful at this point to dwell on the rationales for and against uniformity—the finely specified and detailed rules, and flexibility—the application of general guiding principles that accord entities the freedom to choose among different accounting treatments to best reflect a "true and fair view." Traditionally, uniformity of standards and detailed rules have been championed because they allegedly enhance credibility. Uniform application decreases the ambiguity of results and variation in reported numbers. Hence, it enhances comparability and possibly decreases audit costs (by minimizing disputes with clients about accounting choices). Yet increasing uniformity also decreases the flexibility of management in making accounting choices, and hence limits its ability to signal expectations about the prospects of the company that are not shared by the public. In other words, compulsory uniformity of standards or detailed rules constrains managers' ability to "best" convey their superior knowledge about the past,

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19 Wriston (2002), *The Solution to Scandals? Simpler Rules*, Wall St. J., Aug. 5, 2002, at A10.

20 1 AICPA, Objective of Financial Statements (1973).

21 2 AICPA, Objective of Financial Statements (1974).

present, and future. If discretion is accorded the manager over which accounting methods to apply in the particular circumstances, he will, if he has incentives to report or signal honestly what he knows, employ the combination of methods that best reflects the "economic reality" of the company. Restricting his choice to a single method or even to a specific menu of such methods limits his ability to convey truthful information if he has incentives to do so. Along with the flexibility, therefore, incentives should be aligned to elicit truthful information from management.

Thus, unless existing deterrents of false reporting are insufficient, the solution is not to limit the information flow by legislating rules of reporting that must be universally followed. Rather, the solution is to increase incentives for truthful reporting and give managers a choice of reporting rules to apply once they have the incentive to report truthfully. Suppose, for example, the manager knows which of four states—A, B, C, or D—occurred. (Say it is state C). If he wishes to report truthfully and he has the freedom to choose a reporting mechanism, he would be able to correctly signal that state C has indeed occurred. If he is provided with a limited menu of mechanisms whereby he could only report coarser partitions, he may be able to report only that either state C or state D has occurred; hence, a loss of information would ensue.

Generally, the role of the Conceptual Framework is to specify the characteristics of the set of information disclosures that would result in efficient resource allocation. Even if not translated into detailed rules, such principles or framework would be useful as benchmarks against which to evaluate the adequacy of accounting practices once properly aligned incentives are in place. As indicated, however, without FSI incentives are not properly aligned with those of shareholders. Therefore, in the current regime, the use of the Conceptual Framework, or for that matter any set of general principles, including those prevalent in the UK, as a sole guide for practice is a hazardous proposition, strewn with pitfalls. The historical proliferation of detailed standards that Wriston deplores in his Wall Street Journal column[22] did not come about in a vacuum. The creation of the FASB as a full-time board, and the formulation of objectives of financial statements, both came on the heels of major accounting abuses and the "pooling mania" of the 1960s. Indeed, left on its own under the "guidance" of the general principles—far less detailed than the FASB's standard—promulgated by the FASB's predecessor, the Accounting Principles Board (APB), the profession did not curb the abuses. The accounting profession created the full-member board (the FASB) with the promise to issue detailed standards to avert the governmental takeover of the standard-setting function. Standards were issued mostly to plug exploitable loopholes. The problem was then, and still is now, the perverse incentives causing the abuses, not the detailed standards. Both the abuses and the

[22] *See supra* note 20 and accompanying text.

detailed standards they triggered were symptoms of the bad incentives. It is simply wrong to think that the rules caused the abuses.[23]

However, implicating incentives alone does not do justice to a very complex problem. A careful analysis of the underlying dynamics of financial reporting reveals two fundamental problems: (1) perverse incentives afflicting both corporate management and auditors; and (2) the non-verifiability of many quantifications currently included in the financial statements, which makes financial statements in their present format under existing GAAP essentially non-auditable.

This second fundamental problem requires some elaboration. Today's 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 of the future are assigned respectable seats in the balance sheets of companies as assets, and a good portion of these end up being reflected as revenues. As an example, consider the Interest Only Strip, shown as an asset in the balance sheets of specialty finance companies under Financial Accounting Standard (FAS) 140.[24] This asset is simply the present value of a future stream of unrealized income, recorded as current income. Its valuation is highly subjective, acutely sensitive to even very miniscule changes in assumptions. It is extremely difficult, even for a well-intentioned auditor, to effectively dispute and reject the projection of a manager wishing to prettify his financial statements. Or consider Rebecca Smith's report 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."[25] It is this sort of largely unverifiable intangible that makes financial statements in this era of technological innovation so difficult to audit and make it so hard to opine as to whether they present a "true and fair view."[26]

One cannot overestimate the insidious effects of such intangibles. These projections, perforce, are made by management, which, as an insider, is in a better position to forecast the outcome of its own decisions and plans. Yet these forecasts constitute "private information" of the management. Typically such private information cannot be perfectly verified ex post. Without the ability to peer into

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23 In any case, an overriding GAAP rule is the principle of "substance over form," by which adherence to the literal rules may violate GAAP. *See* Qualitative Characteristics of Accounting Information, FASB Concept Statement No. 2 160 (Financial Accounting Standards Bd. 1991).

24 Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities Research and Dev. Arrangements, Statement of Financial Accounting Standards No. 140 (Financial Accounting Standards Bd. 2000).

25 R. Smith, *Show Business: A Blockbuster Deal Shows How Enron Overplayed Its Hand, Company Booked Big Profit From Pilot Video Project That Soon Fizzled Out, "I Just Couldn't Believe It*," Wall St. J., Jan. 17, 2002, at A1.

26 We do encounter sweeping admonitions in the press to the effect that accountants should make sure that "GAAP fairly portrays the underlying economics." *See* S. Liesman, *SEC Accounting Cop's Warning: Playing By Rules May Not Ward Off Fraud Issues*, Wall St. J., Feb. 12, 2002, at C1 (quoting Michael Young, a defense attorney who specializes in securities fraud).

the manager's mind, we can only observe, in hindsight, whether his forecasts were accurate. We cannot assert that he did not truly believe that the forecasts he made were truthful. Under these circumstances, in equilibrium, and on the average, managements' presentations will not be truthful.[27] Even the detailed standards did not prevent the unverifiable intangibles from creeping into the financial statements. Imagine what would happen if we rely only on "underlying principles!" Thus, I conclude that under the existing regime, detailed rules, improved so as to rule out fair valuations that are based on projections by the privately informed insiders, are a necessary evil.

With some GAAP reform,[28] however, the introduction of FSI may make it possible to minimize the rules and emphasize reliance on the Conceptual Framework in the day-to-day business of making accounting decisions. Under FSI, the auditor who adopts the perspective of the insurer, and hence the perspective of investors, would insist on such accounting choices that conform with the Conceptual Framework as would approximate as closely as possible the "true and fair view" of the enterprise that he, the auditor, perceives after having completed his audit. The potential for misleading the investors would be minimized.

3.6 Potential GAAP Improvements

There is room for improvements in the Conceptual Framework and in the specification of which reported numbers should be subjected to audit. Under the prevalent accrual basis of accounting, projections, typically reflecting future events that management can predict better than the auditor, are endemic to financial reporting. Projection enters into the quantification of accounts receivable, inventory, liability for warranty, and so on. Assets may be reflected at the amount paid to acquire them (verifiable but largely uninformative), at the amount of their expected benefits (possibly informative but mostly unverifiable), or at a blend of both. While investors need to assess the future of the companies they buy and sell, only the past can be verified. The dilemma is pervasive, perhaps existential—not unique to accounting—recalling Kierkegaard's lament: "Life can only be understood backwards; but it must be lived forwards." It is deplorable that the accounting regulators have allowed the intangibles—the soft, unverifiable projections—to contaminate potentially verifiable financial statements. Blended with the verifiable, they are mostly hidden from vision: witness the obfuscation in Enron's financials. The projections, perforce emanating from companies' management, are plagued by future uncertainty, undue optimism and exuberance, or worse, prevarication; not even the most skilled auditors can verify them.

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[27] Ronen and Yaari (2002), *Incentives for Voluntary Disclosure*, 5 J. Fin. Mkts. 349, 362, 372-73 (2002).

[28] *See infra* Part VI.

The statement of the problem points to the solution: unbundle the verifiable past from the unverifiable future while providing both in the financials. Present systematically the projections (the unverifiable), and along with these but separately from them an account, over time, of how the projected future unfolded as evident in what now has become the past—the realizations (the verifiable).[29] By displaying the expectations and the realizations explicitly, side-by-side, investors will reap two benefits.

First, over time they will be able to evaluate how managements' projections pan out and thereby jointly judge their ability to anticipate the future or their proclivity to be optimistic or deceitful. Admittedly, this will not cure the occasional ambitious executive's unsavory proclivities if he reckons his rosy projections will inflate the value of his stock or options, which he can then sell at great profit and jump ship before the storm (Enron comes to mind again).

But investors would not be fooled; herein lies the second benefit of this suggested solution. Having decoupled the realizations—the verifiable—from the expectations—the unverifiable, auditors will attest only to the former; this is what they do best. The projections—chancy and unreliable—cannot be verified, so they cannot be audited. Instead, perhaps just like cigarette packages, they should explicitly carry the label: "These projections may be hazardous to your financial health." Knowing that the projections are unverifiable and potentially hazardous, investors will beware. To the skeptic who may protest that this could discourage investments and risk-taking, my answer would be that investors are better off being aware of the risks they are taking rather than taking risks unaware. A more efficient economy will emerge.

This suggested GAAP reform thus entails three distinct, albeit potentially complementary elements:

1. Separation of unverifiable projections from verifiable realizations;
2. Having the auditor attest only to the latter;
3. Assuming FSI is implemented, the auditors can rely on the Conceptual Framework without the detailed rules, with more impunity: auditors' incentives are sufficiently aligned to minimize abuses.

FSI is an essential remedy. Even if GAAP is reformed as suggested and the auditors attest only to the verifiable, incentives must be properly aligned. The verifiable realizations themselves vary in the degree of their verifiability: they include more than just cash. Although they exclude long-term projections such as the predictions of earnings from intangibles or contracts that may extend over many years into the future, they do include projections that span relatively shorter periods. In other words, the verifiable will include short- term accruals. For example, sales revenue will still be recorded upon realization—when the earnings generating process is essentially completed and collectibility is reasonably

[29] *See generally* Ronen and Sorter (1972), *Relevant Accounting,* 45 Bus. 258, 258-282 (1972) (providing a detailed description of how such a financial reporting system can be implemented).

assured. This sales transaction would be defined as a realization—verifiable and subjected to audit. Yet many of the recently publicized abuses, Worldcom, Enron, and others, resulted from the misrecognition of revenue. Thus, even with this GAAP reform, auditors will need to be sufficiently motivated to apply the necessary degree of skepticism.

Items (1) and (2) above can be beneficially implemented independently of FSI. They can also complement FSI in synergistically magnifying the benefits. In particular, in conjunction with FSI, these reforms will make it more feasible to do away with the bright line rules that greatly offend a growing number of critics.

3.7 A Future Role for the FASB

What would be the role of the FASB or any other "standard-setting" body in an FSI regime where a modified Conceptual Framework, as suggested above, would govern, and where there is no demand for the promulgation of detailed standards? I envisage a vital role—akin to that of the courts—of laying down the "case law" of financial reporting.

Disputes will inevitably arise between the auditor working for the insurer and the management of the company being audited with respect to how best to apply the Conceptual Framework to a particular transaction or situation. It is in this context that the FASB can play a role akin to that of a court. Presumably possessing accounting expertise and rich practical experience, the accounting board members can offer guidance that helps resolve disputes that arise in the process of auditing. The FASB can develop a compendium of specific applications of the Conceptual Framework to transactions in the process of providing guidance to the disputing partners. Such a compendium could serve successfully as the "case law" of financial reporting, just as the case law in the judicial domain successfully serves the nation's judges.

3.8 Conclusion

In the introduction of this essay, I enumerated several causes implicated in the media and in academe in precipitating the "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 conflict of interest that inheres in the auditor– client relationship probably is the major culprit, reinforced and fed by some other factors. 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.

The reform measures adopted so far, including the Act, are inadequate. A market-based solution that properly realigns auditors' incentives is a necessary complement. I suggest a particular market mechanism, Financial Statement Insurance, for implementation. The insurance yields multiple benefits, only one of which is the vitally important elimination of the auditors' inherent conflict of interest. The publicization of the insurance coverage and the premium under the particular mechanism I am suggesting will credibly signal the quality of the insured's financial statements. These signals will be priced into the equity and debt securities and thereby make the prices of these financial instruments better guides for investments. As a result of this better channeling of savings into the reliably worthier projects, social dividends will be earned. At the same time, companies will have incentives to improve the quality of their financial statements and do so. This, along with the consequent improvement in audit quality, will result in fewer misrepresentations and accordingly in fewer suits and stakeholder losses; the deadweight social cost of litigation will significantly diminish.

Financial statement insurance is a free market mechanism, so it should not require new legislation. Nonetheless, the market institutions that would be responsible for implementing it, the insurers, the insured, and the risk assessors, will need to gear up for the necessary contractual arrangements. This may be time consuming. It therefore may be advisable to jumpstart the remedial process through an interim regulatory initiative, one that is temporary and that would "self-destruct" once the market institutions have been able to set up the required infrastructure. For example, the SEC could mandate financial statement insurance at some minimum coverage, where the minimum could be determined as, for example, a properly computed multiple of the largest negative earnings surprise experienced by the insured over the last three or five years. A federal insurer could be incorporated for this purpose; that would be financed mostly by the premiums collected from the insureds. This organization's accumulated experience will inform and guide the market as to the appropriate risk pricing. With time, the market institutions will replace the government, bringing an end to the temporary engagement.

Furthermore, independently of this mechanism but potentially complementing it, I also suggest GAAP reforms: separation of the unverifiable from the verifiable in financial reports, and presentation of management's projections in the financial statements along with the consequent realization. This will allow investors to judge managers' skill in forecasting. Also, to improve the reliability of the audit, the auditor should attest only to the verifiable. In this way, investors would become more aware of the risks surrounding their investments. Together with FSI, or even with FSI alone, a financial reporting practice that relies solely on general principles, a Conceptual Framework, will become possible; the need for detailed rules would be obviated.

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