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ROSS ROUNDTABLE

on

Audit Committee Reforms: Requirements of the Sarbanes Oxley Act and Consideration of Financial Statement Insurance

Date & Time: Monday, January 27, 2003 from 4:00pm to 6:00pm

Location: New York University
Leonard N. Stern School of Business
44 West 4th Street
Kaufman Management Center
Cantor Boardroom, 11th floor (11-75)
New York, NY 10012

Contact: **212-998-4143 or 212-998-4144**

Roundtable Coordinator:
Joshua Ronen, Professor, *Department of Accounting, Taxation and Business Law*

Roundtable Theme

Last fall, Enron's collapse stunned the nation. A shocking series of revelations of accounting irregularities by certain major corporations followed. What happened?

Several culprits have been suggested: investors' irrational exuberance, infectious greed, and foolishness; the bursting of the bubble; the impoverished morality of certain CEOs; the tendency to cook the books; the failure of the gatekeepers; and the rules oriented financial reporting system, which have permitted auditors to acquiesce in accounting gimmicks and earnings management.

Unfortunately, these alleged causes cannot be remedied with equal effectiveness. Prosecution and punishment may not adequately deter wrongdoing, as intentional misrepresentation is difficult to discover or prove. Overhauling the regulatory structure and adding layers of supervision and monitoring by the government may be inefficient and as ineffective as in the past. Moreover, little can be done in the short run to cultivate ethical personalities, and it is not necessarily desirable to curb investors' enthusiasm. It has been suggested that the solution lies in market mechanisms that eliminate the perverse incentives of gatekeepers, most notably the auditors. Financial statement insurance ("FSI") has been proposed as one such market mechanism.

It has been argued that financial statement insurance (FSI) would change the principal-agent relationship. Instead of appointing and paying auditors, companies would purchase insurance that provide coverage to investors against losses suffered as a result of misrepresentation in financial reports. The insurance coverage the companies obtain would be publicized, along with the premiums paid for the coverage. The insurance carriers would appoint—and pay—the auditors, who would attest to the accuracy of the financial statements of the insurance company's prospective clients.

Companies 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 those with lower quality financial statements. Every company would be eager to avoid this characterization. A sort of Gresham's law in reverse would be set in operation, resulting in a flight to quality.

We would like to explore the potential, cost, benefits, and risk of this proposed scheme as well as others. Among the questions to be addressed are the following:

1. Are audit committee reforms, such as the structure of the committees, the requirement for independent director experts, the need to approve all audit and permitted non-audit services, and the monitoring of internal controls, sufficient to prevent financial statement fraud?

2. Does the bar to non-audit services introduced in the Sarbanes Oxley Act eliminate the auditor's conflict of interest and assure independence?

3. Do the harsh penalties of the Act constitute an effective remedy against the temptation to cook the books? Are the penalties imposed too late to prevent market disruptions and large losses to investors?

4. Recoupements of audit legal liability are ultimately made out of the corporation's resources. Does this imply that shareholders end up paying for the auditor's insurance for amounts the shareholders expect to recover from the auditors? Does this mean shareholders end up paying themselves for the damages they suffer?

5. Will FSI result in better audits? Will FSI result in a better signaling of financial statements' quality through the premium and the coverage that are publicized? Will FSI result in a decrease in shareholder losses?

6. It has also been argued that, an accounting approach that is based on underlying principles rather than detailed rules would improve financial reporting. Is this the case? Is it advisable to shift to a "principle" regime without FSI? If incentives to "cook the books" are not eliminated, will general principles offer better protection than detailed rules?

7. Can post-Enron reform in the auditing profession be reinforced by a GAAP reform? Should "fair value" quantifications exclude methods that involve largely non-verifiable projections of cash flows? Should the latter be provided separately without auditor attestation or with an attestation that carries a lesser degree of assurance?

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