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The Public Auditor as an Explicit Insurer of Restatements: A Proposal to Promote Market Efficiency

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I. Introduction

We present a radical and admittedly ambitious proposal for reform of the public auditor-client relationship. We suggest the creation of incentives to permit public auditors to form, as an optional matter, audit risk insurers to assume the risk of a deficient public audit. We discuss in turn (i) the need for this radical structural change, (ii) why the change will produce benefits justifying the cost and dislocation resulting from implementing it, (iii) how it will work, (iv) the incentives necessary to bring it about, (v) the need for a transition period, and

(vi) the resulting benefit to not only the audit process but also the promotion of efficiency in the securities markets.

In our view, embarking upon radical structural reform is worth the risk of unforeseen consequences. An enhanced audit process should result in more meaningful disclosure to investors and other corporate constituencies with the consequence that earnings surprises and resulting stock price volatility will

be significantly reduced. Since investors will correspondingly have greater expectations of certainty, valuations should increase. Last but not least, litigation costs from securities class action and other shareholder litigation should substantially decline. We suggest and endorse this proposal because we think that there will be a sufficient likelihood of achieving these ends. We suggest an entirely optional approach catalyzed in the first instance by incentives since we believe that the likelihood of achieving these ends alone may not sufficiently incentivize the creation of audit risk insurers and the willingness of corporations to pay the risk premiums which will be required for audit risk insurers to assume the risk of deficient public audits.

II.. The need for Structural Reform

Even with changes in the auditor-client relationship mandated by The Sarbanes Oxley Act of 2002 ("SOX") and supervision of auditors by the Public Company Accounting Oversight Board ("PCAOB"), the current auditor-client relationship does not produce optimal results or, to put it more bluntly, does not work well for users of financial statements. To put it succinctly "[D]espite these reform innovations, commentators identify continuing limitations in the structure of auditing." Indeed, rather than decreasing, the number of restatements has continued to increase since the enactment of SOX.

The complexity of transactions

The problems that inhere in the historical structure of the auditor-client relationship have been aggravated by advances in technology and increased sophistication in the engineering of financial contracts. At least two major changes have had a significant impact on the auditor: the computer and the change in the nature of assets and liabilities. The computer has substantially expanded the amount and quality of data available and the auditor has become dependent on data processing systems. The movement from tangible to intangible assets with very long lives and from liabilities whose principal and terms are known and specified to liabilities whose principal and terms are legally related to and dependent on other factors, as exemplified by derivatives, has substantially reduced the auditor's ability to validate the values presented in the financial statements. Current financial statements are a blend of largely verifiable, but not very useful, depictions of past transactions and largely unverifiable but potentially useful, projections of future outcomes. Under existing GAAP, many of those projections show up in the balance sheets as assets, and even as revenues. For example, consider the Interest Only Strip, shown as an asset in the balance sheets of specialty finance companies under Financial Accounting Standard 40. This asset is simply the present value of a future stream of unrealized income, recorded as current income. Its valuation is highly subjective and acutely sensitive to changes in assumptions.

It is extremely difficult, even for a well-intentioned auditor, to dispute and reject the projections of a manager wishing to improve the appearance of his financial statements. Such largely unverifiable intangibles make financial statements difficult to audit since private information cannot be perfectly verified ex post. No matter what the outcome of a manager's forecast, it is exceedingly difficult to determine if he believed the forecasts were reasonable when made. Research has shown that under these circumstances, in equilibrium, and on average, managers' presentations will not be truthful.[2]

The changed environment puts the auditor in a very difficult position, especially within the extremely competitive market for audit services. In an uncertain environment marked by the difficulty of verifying valuations that are necessarily soft and subjective, an auditor who is paid by a potentially prevaricating client is naturally tempted to adopt the client's position. Thus, although some audit failures have been precipitated by incompetence and corruption, the subjective conditions that created audit uncertainty likely contributed to these failures. It certainly seems, whether proved empirically or not, that there are far too many restatements and earning surprises due to an inability to predict future cash flows

[2] J. Ronen and V. Yaari, "Incentives for Voluntary Disclosure" Journal of Financial Markets 5 (2002) 349-390.

and calibrate other valuation metrics with optimal confidence. While we are confident that SOX has to some extent eliminated the more egregious aspects of the fee for service conflict of interest between audit clients and auditors, the problems inherent in a structural conflict of interest still exist; and history shows that periods of manifested greed are cyclical.

The principles versus rules debate

With the increase in complexity of business transactions, the auditor's structural conflict of interest has manifested itself in the principle versus rules debate raging within accounting circles. Users have been caught in a maze of rules which lead potentially to opaqueness rather than transparency and which at the heart of things are applied by audit firms who are paid by their clients. In the aftermath of accounting scandals, many called for abolishing the bright-line rules which were seen to permeate the accounting standards and to move to a principle-based

system.[3] In its commentary on this subject, an American Accounting Association Financial Accounting Standards Committee expressed its support for a concepts-based standards approach:[4]

> The Committee strongly supports the commitment by the FASB to evaluate the feasibility of concepts-based standards. We believe that the economic substance, not the form, of any given transaction should guide financial reporting and standard setting, and that concepts-based standards represent the best approach for achieving this objective. Rules-based standards provide companies the opportunity to structure transactions to meet the requirements for particular accounting treatments, even if such treatments don't reflect the true economic substance of the transaction. We recognize, however, that the current plethora of detailed rules has been demand-driven, suggesting that companies may request more guidance than that provided by concepts-based standards. Additionally, a change from rules-based to concepts-based standards magnifies the importance of informed professional judgment and expertise for implementation of standards. Overall, however, we believe that concepts-based standards, if applied properly, better support the FASB's stated mission of..." improving the usefulness of financial reporting by focusing on the primary characteristics of relevance and reliability..."

Some have argued that detailed standards provided self-interested managers the opportunity to manipulate the reported results under the guise of

The FASB approved the new project on Codification and Simplification on January 9, 2002. Members of the FASB board/staff and accountants also refer to concepts-based standards as principles-based or conceptual standards. Rules-based standards are sometimes referred to as bright line or cookbook standards.

[4] Chair Laureen A. Maines and others, "Evaluating Concepts-Based vs. Rules-Based Approaches to Standard Setting." *Accounting Horizons* 7, no. (2003) 73-89.

complying with the rules.[5] Auditors, paid by their clients, typically would find it more difficult to thwart such manipulations when the managers cite the rules for justification. On the other hand, audit committees have been found to be more likely to support auditors in disputes with management when the issues involve technical standards.

Concepts-based standards are not a panacea since the standards must still be "applied" properly. Managers can still choose accounting treatments that do not reflect the underlying economics of a transaction. Managers, audit committees, and external auditors must have the desire for unbiased reporting, as well as the expertise, in order for conceptual standards to result in financial reports that faithfully reflect the underlying economics. Unfortunately, these qualities may not be in abundant supply. For example, researchers have found evidence that indicated auditors are less able to resist client pressure for aggressive reporting when there is a wider range of acceptable accounting alternatives[7] and have found that flexible standards are associated with greater conflict and more negotiations between auditors and clients.[8]

It is an open question whether a move away from detailed rules will significantly decrease the incidence of omissions and misrepresentations in financial statements under the existing regime in which, because being beholden

to their clients, auditors are unable forcefully to resist client pressures. Indeed, despite SOX's provisions and the SEC's urging that concepts (substance) be followed rather than rules (form), restatements implying past misrepresentations have not declined in number. Contrawise, restatements have increased.

[5] Examples the committee cites include Pulliam's (S. Pulliam, "Beating FAS 3." *Corporate Finance* 3 (December, 988), finding that third-party guarantors of the residual values of leased assets developed contracts to avoid the "90% present value of minimum lease payments" threshold imposed by SFAS No. 3, and Imhoff and Thomas (E. Imhoff and J. Thomas, "Economic Consequences of Accounting Standards: The Lease Disclosure Rule Change." *Journal of Accounting and Economics* 0 (December, 988) 277-3 0, who find that the most common effects of SFAS No. 3 was the substitution of operating leases for capital leases, possibly in order to avoid the recognition of liabilities.

M. Knapp, "An Empirical Study of Audit Committee Support for Auditors Involved in Technical Disputes with Client Management." *The Accounting Review* 2 (July, 987) 578-588.

[7] G. Trompeter, "The Effect of Partner Compensation Schemes and Generally Accepted Accounting Principles on Auditor Judgments." *Auditing: A Journal of Practice & Theory* 3 (Fall, 994) 5 - 8.

[8] M. Gibbins, S. Salterio, and A. Webb, "Evidence about Auditor-Client Management Negotiation Concerning Client's Financial Reporting." *Journal of Accounting Research* 39 (December, 200) 535-5 3.

The trend of restatements

The Figures below reproduced from Figures 2 and 3 of the 200 GAO Report[9] on financial restatements present the number of restatements over the period 997 to September 2005. According to the GAO report, while the number of public companies restating their publicly reported financial information due to financial reporting fraud and/or accounting errors remained a relatively small percentage of all publicly listed companies, the number has grown since 2002: 3 4 companies announced restatements in 2002 and 523 announced restatements in 2005 (through September) an increase of approximately 7%, and a nearly fivefold increase from 92 in 997 to 523 in 2005. In addition, of the ,390 announced restatements that were identified, the percentage of large companies (over $ billion in total assets) announcing restatements has continued to grow since 2002. On a yearly basis, the proportion of listed companies restating grew from 3.7 percent in 2002 to .8 percent in 2005 (GAO Report, Figure 3, reproduced below).

Restating by large companies (i.e., companies having over $ billion in total assets), as a percentage of the total companies restating, has increased from about 30 percent in 200 to over 37 percent in 2005. Likewise, the average market capitalization of companies announcing a restatement (for which data were available) has grown from about $4 billion (with a median of $282 million) in the latter half of 2002 to almost $ billion (with a median of $ 72 million) through September 2005. [0]

[9] United States Government Accountability Office 200 , FINANCIAL RESTATEMENTS: Update of Public Company Trends, Market Impacts, and Regulatory Enforcement Activities. GAO-0 - 78 (July, 200) ("200 GAO Report").

[0] The 200 GAO Report (p. 4) provides data on the increase in the number of restating firms

broken down by exchanges: “Another indication that large public companies announcing restatements has continued to increase, is the number of companies identified as announcing restatements that are listed on the NYSE, which has more large companies than the other U.S. stock exchanges (p. 5). For example, between 2002 and September 2005, the number of NYSE-listed companies announcing restatements had increased 4 percent from 4 to 87 (p). During the same time, the number of NASDAQ-listed companies announcing restatements increased 55 percent from 37 to 2 2, and the number of Amex-listed restating companies increased more than 75 percent from 4 to 40.”

In light of this problematic experience, we have struggled with the question of whether there is a better way to structure the public auditor-client relationship—mindful of Joshua Ronen’s pioneering efforts for Financial Statement Insurance but still seeking a better way. Indeed, we have struggled with the question from the point of view of not simply seeking a sanctimonious cure for a structural conflict of interest but, rather, with the goal that the right approach might, on the one hand, provide auditors with the benefits of true independence and, on the other hand, benefit their clients by increasing the likelihood that more transparency involving better signaling to the securities markets would reduce stock price volatility, improve valuation ratios, and thus enhance equity and debt valuations.

III. Auditor Assumption of Risk of GAP Deficiency Damages

We set forth the outline of a proposal for public auditors to assume liability for what we call “GAAP Deficiency Damages”. Again the proposal is intended to be provocative and, indeed, cannot be accomplished without legislative amendments to securities, tax, and other laws. Nevertheless, we hope that it generates constructive criticism, if not controversy.

Our Proposal:

A. An auditing firm would be incorporated with full limited liability as an audit risk insurer (“ARI”) for the purpose of assuming liability for GAAP Deficiency Damages resulting from a restatement of financial statements audited by the ARI. An existing audit firm could incorporate itself fully, or more likely, on a test basis incorporate an ARI as an affiliate for the conduct of certain audits, or an existing insurer or other risk bearing financial institution could establish a monoline auditing insurer subsidiary. Since the fullest assumption of professional and ethical responsibility would be essential to both the integrity of the audit and limiting the risk assumed by the ARI, the board of directors and the chief executive and operating officers should be certified public accountants. For similar reasons, the capital required by the ARI should be conflict free and, thus, might likely be private, restricted, and vetted by the audit firm.

B. The ARI would insure against a restatement of the financial statements of its client. We realize that, in theory, financial statements could be misleading without violating GAAP, but such situations should be rare and possibly the more so with the passage to a principle-based GAAP from a rule-based regime. We also

See, for example: J. Ronen, “Post-Enron Reform: Financial Statement Insurance and GAAP Re-Visited.” *Stanford Journal of Law, Business and Finance* 8 (2002) 39- 8; and Susan Lee, “A Market Remedy for Our Nasty Accounting Virus.” *The Wall Street Journal* (July 0, 2002).

recognize that while restatements are to a large extent a measure of audit quality, they fundamentally and inherently point to a problem in financial statement quality. Increases in the number and rate of restatements have contributed to a widespread concern over audit quality. But the increase in restatements has also

coincided with an increase in the percentage of executives' pay based on stock performance which some have argued has significantly increased the incidence of earnings management and manipulation [2], thereby degrading financial statement quality. But even though restatements may not be conclusive proof of a decline in audit quality, we believe that if auditors assume the risk of restatements both the quality of audits and the quality of the underlying financial statements prepared by the clients will improve as auditors are incentivized to demand higher quality financial statements.

We recognize that if the ARI is insuring against losses triggered by a restatement, the ARI when performing its audit function might have a disincentive to restate an earlier financial statement audited by the ARI. However, we do not think that this disincentive is any greater than the disincentive which currently exists with respect to an auditor facing the prospect of suit due to restating its prior audited financial statements. The ARI and individual auditors would be subject to full regulatory and criminal enforcement action, and we would suggest an ARI be subject to specific regulatory and criminal sanctions in the event of a willful avoidance or delay in a restatement. More importantly, delaying an inevitable restatement would likely increase GAAP Deficiency Damages with the result that the ARI would assume even greater risk. Since the ARI would be insuring a particular financial statement against a restatement, an ARI cannot run away from responsibility for its prior audits.

C. In the event of a restatement, the ARI would pay eligible claims by paying into an SEC Fair Fund a sum which would be capped at 0% of an amount equal to the average daily decline in the stock price of its audit client, from the closing market price on the 0th day prior to the first announcement of a restatement (to allow for the effects of prior announcements of an impending restatement) until the 0th day following the restatement announcement, multiplied by the non-insider public float in the client stock ("GAAP Deficiency Damages"). Any purchaser of the audit client's equity securities who purchased subsequent to the issuance of financial statements which are later restated and who holds until the first announcement of the restatement would be eligible to submit a claim to the fund for its loss (subject, perhaps, to equitable offsetting adjustments such as offsetting profits and hedges).

[2] John C. Coffee, Jr., "What Caused Enron? A Capsule Social and Economic History of the 990's, 2003." *Working Paper, Columbia Law School Working Paper Series, New York.*

We think that a cap is necessary for a few reasons. The simplest reason is that we are unsure whether sufficient risk capital can be raised by ARIs to assume the liability of a full decline in market capitalization. The Supreme Court has restricted liability under the securities laws emphasizing that these laws do not "…provide investors with broad insurance against market losses", [3] and only provide a private remedy to purchasers and sellers. [4] There is accordingly no experience with insuring auditor liability based upon an overall decrease in market capitalization. Thus, we believe that economic realities require limiting the assumption of liability by auditors to liability to purchasers of securities, and by discounting market capitalization losses to recognize that ( ) decreases in stock prices are often due to causative agents other than the accounting restatement even if a price decline may be associated with a restatement and (2) purchasers' damaged shares are usually fewer than the shares in the float.

More fundamentally, more than compensating investors for losses per se, our proposal is directed to preventing misrepresentations and to reducing stock price volatility by creating an incentive structure that will deter misrepresentations a priori. From this point of view, what is necessary is that auditors assume liability to the extent necessary to provide sufficient incentives to maximize audit diligence. To put it bluntly, what is required to achieve these policy goals is an assumption of liability to the degree necessary to hold the ARI hostage. The amount of assumed liability which will hold the ARI responsible but nonetheless encourage the creation of ARIs will necessarily have to be fine-tuned, which is one of the reasons why we propose a transition period.

The 0% multiplier to cap liability (which is suggested for present purposes pending experiential developments) is derived from the median settlement amount, as a percentage of estimated damages, of class action shareholder suits during the period of 997–2004 which was 4.9% (as reflected in the following chart reproduced from a 200 study [5]). We adjusted this percentage upward to 0%, as an a priori proposal, mindful of the fact that the 4.9% median settlement incorporates an assessment of the probability that plaintiffs will not prevail in an eventual trial on grounds of their inability to prove falsity, scienter, materiality, causation, or other requirements of liability. The proposed ARI assumption of liability, unlike litigation liability, is a "no fault" concept not involving the proving of requirements for securities law violations. We also are mindful that the financial capability of defendants affects settlements.

[3] Dura Pharmaceuticals Inc. v. Broudo, 544 US 33 , 345 (2005).

[4] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit, 503 (200); Blue Chip Stamps v. Manor Drug Stores, 44 U.S. 723 (975).

[5] Laura E. Simmons and Ellen M. Ryan, "Post-Reform Act Securities Settlements 2005 Review and Analysis" (200) -20.

The cap could be altered in the light of future experience. We acknowledge that there will be a devil in the details and a need to consider details in the light of experiential results which again is one of the reasons why we do suggest a transition period.

D. The ARI would charge the audit client a fee comprised of a service fee for the audit and a risk premium for assuming liability for GAAP Deficiency Damages. The risk premium would be computed as the expectation of the contribution to the Fair Fund in the case of a restatement; thus, the premium should equal a projected contribution to the Fair Fund times the probability of a restatement. Naturally, both the projected contribution to the Fair Fund and the probability of restatement—the two components of the premium calculation—would be company and circumstances-specific. The contribution would depend on the actual stock price impact of a restatement, which would vary from one company to another, while the probability of a restatement would depend upon the relative strength of internal control procedures, the degree of subjectivity inherent in estimates necessitated given the nature of the company's transactions, as well as other company-specific factors.

It may be helpful to speculate on the order of magnitude of risk premium on average. First, a "back of the envelope" calculation of what might be a reasonable amount of the contribution to a Fair Fund can be performed from GAO data. The 200 GAO Report estimated that for ,0 cases analyzed from July , 2002, to

September 30, 2005, the stock prices of companies making an initial restatement announcement fell by almost 2 percent (market-adjusted), on average, from the trading day before through the day after the announcement (the immediate impact). Table 3 of the 200 GAO Report at p.24, reproduced below, shows that on an annual basis, and when not adjusted for market movements, the average annual decline was $ 3. billion. However, when market-adjusted, the average decline was $ 9.4 billion.

As indicated, the immediate market-adjusted impact on the stock price was about 2%. With respect to the longer-term impact, on a market-adjusted basis, from 0 trading days before through 0 trading days after the announcement of the restatement, the GAO estimated that the stock prices of restating companies decreased by less than 2% on average. The longer time frame allows the capture of any impact from earlier company announcements, which may have signaled a restatement such as a company's CFO departing suddenly, its outside auditor resigning, or notice of an internal or SEC investigation at the company. However, longer event windows (0 trading days before through 0 trading days after the announcement of the restatement) include the impact of other events that may have occurred over the longer time period. The GAO cites as an example speculation about potential accounting problems at AOL that first appeared publicly in mid July 2002 in The Washington Post, when it was not until mid-August that the company announced it would restate. The immediate impact around August 4, 2002 (the announcement date) was positive, while the earlier disclosures' impact was negative.

There are at least two significant caveats to the GAO analysis. First, the analysis only attempts to control for overall market movements and not for company-specific news unrelated to the restatement including positive news such as a company winning a lucrative contract or becoming an acquisition target, both of which would result in a positive impact on the stock price. Second, the returns were adjusted for market-wide movements but not for the movements in an index of carefully matched peers' stock returns.

Suppose nonetheless for present purposes, we adopt the 2% average relative decline in the stock price as an estimate of shareholder losses per share upon the announcement of the restatement. Applying a 0% multiplier as a cap, we obtain a 0.2% expected contribution percentage. This 0.2% then would be applied to a projection of the total market value of the float at the time of the announcement of the restatement to estimate a projected contribution to the Fair Fund. For example, if the value of the float is estimated at $5 billion, the likely exposure to the ARI (the contribution to the Fair Fund) would equal, on average, 0.2% of $5 billion, or $ 0 million.

Since, as shown above, the probability of restatement was .8% (percentage of listed companies restating in 2005), the risk premium would then be set at .8% of $ 0 million, or $ 80,000. As indicated, this computation can and will be refined to take into account the ARI's view of the risk of restatement depending upon the ARI's assessment of audit risk, subjectivity of GAAP issues, integrity

of management, as well as other factors. The computations here should be viewed merely as an illustration of the methodology for the calculation of risk premium—in many instances, risk premium might be considerably higher due to an assessment of higher risk. The actual risk premium might also include a specific factor for underwriting profit and, as mentioned, would be in addition to an audit service fee which would vary according to the complexity of the audit. Since the risk premium would be a significant signaling mechanism for the securities markets, we propose that the audit client be required to disclose publicly in its SEC filings the amount of risk premium it is paying. We would also endorse a requirement that the audit client disclose the range of competing bids by ARIs for risk premium although we have some hesitation that it might create a disincentive for the client to obtain multiple, formal bids.
Audit clients disclosing lower premiums would distinguish themselves in the eyes of the investors as companies with higher quality financial statements.

In contrast, those with lesser or no coverage or higher premiums would reveal themselves as having lower quality financial statements. A company should be eager to pay lower premiums, lest it be identified as the latter. A sort of Gresham's law would be set in operation, resulting in a flight to quality.
Assuming a semi-strong efficient stock market, the publicized coverage of the risk 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 might include omissions or misrepresentations. The ARI

concept would satisfy the conditions required for a signaling equilibrium . The market would be able to compare different companies and assess which presented more reliable financial reports. These different qualities would be reflected in the price of securities of ARIs' clients in securities markets, contributing to market completeness.

The price of the ARI clients' securities would reflect the degree of credibility of the underlying financial statements, as reflected in the risk premium.

The resulting more accurate pricing of securities would help institutional and individual investors 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.

A company with better quality financial statements would have an incentive to signal its superiority to the marketplace by demonstrating that it can obtain ARI audited financial statements at a lower premium than other companies in its industry. A company with poorer quality financial statements would be forced to reveal the truly lower quality and reliability of their financial reports: either it would pay a higher risk premium or it would decide not to engage an ARI to audit its financial statements. The company now would find it in its best interests to improve its internal and subjective estimation processes controls so as to qualify

for a lower risk premium. By actually improving its procedures to induce the ARI to assess a low premium, it would signal to the marketplace the improved quality of its financial statements, resulting over time in a higher price for the company's securities.

E. The ARI would have immunity from liability under the securities law for its insured audits since its direct assumption of risk would provide the highest incentive for professional auditing. Indeed, we can foresee the truly independent risk-assuming auditor insisting on the greatest transparency not only for the fullest compliance with GAAP but also to reduce market price reaction in the event of a restatement. Indeed, the auditor would be incentivized to require that, one way or another, its audit client signal potential problems so that its stock market price behavior smoothes out. In these circumstances, there is little need for auditor liability, with its attendant high litigation costs, under the securities law.
Dontoh A. J. Ronen, and B. Sarath, "Financial Statements Insurance." SSRN Working Paper Series, http://ssrn.com/abstract=303784 (2004).

F. The corporate audit client and its directors and officers would likewise have substantial immunity under the securities laws from liability directly arising from the restatement but not otherwise. They would not, however, have immunity for restitution claims (inclusive of claims for the sale of securities under Section of the Securities Act of 933 arising from a restatement) or from other claims not involving a restatement, and equally importantly, would be subject to liability to the ARI for GAAP Deficiency Damages paid by the ARI into the SEC Fair fund to the extent that the ARI was not at fault. Presumably, an appropriate expedited arbitration forum would resolve such liability. Likewise directors and officers would also have liability to the ARI when the ARI was not at fault, but, correspondingly, they would have their customary rights to indemnification from the corporate audit client for their liability (assuming their conduct met the requisite standards). The corporation and its directors and officers would also not

be immune from regulatory or criminal enforcement action.

This aspect of the proposal is not put forth without some doubts. However, the relatively high cost to the corporation of the risk premium is pivotal to our thinking that immunity is worthwhile. On the one hand, the corporation will need an incentive to pay a substantial risk premium to the ARI. On the other hand, the risk premium will change from year to year depending upon the perceptions of risk; and an increasing premium will be a substantial signal to the securities market of investment risk. This negative signaling should translate to lower stock prices imposing a substantial penalty and disincentive for financial irregularity. For this reason, once a corporation elects to proceed with an ARI, there must be a lockup period so that it cannot run away from the penalty of the higher risk premium in subsequent years with its negative signaling connotations. We hope and expect that those corporations which have the self perception that they have the least to fear with respect to restatement and financial irregularity will embrace the ARI concept because of its positive signaling benefits creating the situation that those corporations that do not elect an ARI audit will be perceived negatively in the securities market place and, thus, will be incentivized, whether or not they prefer it, to have an ARI audit. We appreciate that there is an economic leap of faith with respect to anticipating these consequences, but we submit this is economically sound reasoning. In any event, a suitable transition period would confirm this reasoning one way or another.

IV. Economic Incentives for the ARI

In addition to immunity from liability as an incentive, we also perceive a need for economic incentives for auditing firms, which are historically professional practice partnerships, to form an ARI on their own or to do so in conjunction

with professional insurers that have no prior actuarial experience directly insuring financial statements. Thus, we propose a number of incentives over a test period:

A. A 00% reserving tax shelter against risk premium in order to permit in effect 00% of the risk premium to be used to pay losses and provide for a build up of reserves. In our view, this is necessary in order to create an insurance product for which there is no prior actuarial experience.

B. The ARI, like any other insurer, would be permitted to offset risk through reinsurance. We also suggest that other hedges, inclusive of synthetic hedges against specific audit client defaults, be permitted on a limited basis subject to disclosure to and supervision by an appropriate regulatory body such as the SEC or the PCAOB. We believe that permitting risk hedging in a novel actuarial situation is important initially to attract capital until at least there is sufficient experience to permit reasonably accurate risk premium pricing. However, we also believe that oversight is important since hedging can create disincentives to audit professionalism.

C. In view of the power of risk assumption as a self regulating mechanism and promoter of auditor professionalism, the ARI would be permitted to engage in currently prohibited ancillary services. In other words, the auditing firm would not be generally prohibited from performing consulting services for an insured. The benefit is that audits would improve since the more the auditor knew about the systems and operations of the insured, the better the auditor could carry out the audit. Moreover, the pool of qualified and respected auditors would grow, because auditors would deem it in their own interest to move toward professional excellence in an effort to garner more audit assignments. For similar reasons, employees should be permitted to transfer between the traditional audit firm and the ARI. We do, however, suggest oversight at least initially, during the period when incentives are seen as necessary to promote the creation and use of an ARI.

V. Experimental Transition Period

A radical proposal will result in some unforeseen consequences. Necessarily, a number of the aspects of the proposal will require special legislative treatment which should not be indelible. Therefore, we do propose a sunset provision. During an experimental transition period in order to determine the relationship between ARI arrangements, audit risk, and expected benefits, we propose that all ARIs report to the SEC or the PCAOB full information concerning profit and loss, pricing of risk premiums, reserving, reinsurance and hedges. We would suggest a study after a five-year period to assess the degree of

implementation of ARIs, the reduction in the number of restatements and earning surprises as a result of the use of ARIs, correlations with stock price behavior, as well as any detrimental aspects to the use of ARIs. If the ARI enabling legislation were not renewed after six years, it should terminate under provisions which would preserve its benefit for ARIs and their clients and their clients' investors for financial statements insured by ARIs during the transition period—in other words, the audit risk liability assumed during the experimental transition period would be "run off" over an additional period—perhaps five years—and no new liability would be assumed so that the ARI would be liquidated with the opportunity for an ultimate profit upon its sunset.

* * *

We are interested in finding out whether there will be sufficient improvements in market efficiency, enhancement of the welfare of investors inclusive of pension funds and retirement investors, and reduction in litigation costs to justify and encourage ARIs. We doubt that our proposal can be justified simply by improvement in the auditor-client relationship alone. An increasingly complex financial world, which begets increasingly complex rules with attendant complex compliance issues, demands better and more transparent signaling to investors. In our view the ARI, powered by its risk assumption attributes, will function as a more efficient intermediary for transmitting financial information to investors and would likely be economically demanded.