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FINANCIAL STATEMENT INSURANCE

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Introduction

The largest corporate bankruptcy filed in the U.S. that of Enron Corp in 2001 was preceded by a string of disclosures about the restatements of their financial statements.[1] The presence of such errors that required restatements of the financial statements brings into focus the salience of two inter-related needs. The first is the need to assess the quality of the information contained in the financial statements as a basis for making projections about the future. The second is the need to actually make projections about future cash flows and aggregate these into a value for the security. Even if one assumes that accurate models are available for projecting cash flows, uncertainty about the quality of the financial statements can lead to pricing distortions and inefficient market allocations.

Several causes have been suggested as culprits that contributed to the current state of affairs. Among these is the tendency by management to inflate stock prices for personal gain through deceit, `cooking the books' along with the consequent misrepresentations in financial reporting; investors' irrational exuberance, infectious greed, and foolishness; the bursting of the bubble; the impoverished morality of CEOs; the bright line financial reporting standards, which have encouraged auditors to acquiesce in accounting gimmicks, and other unethical behavioral practices, and more importantly, the failure of the auditing profession to fulfill their role as independent gatekeepers. Currently, the incentives driving auditors' behavior may not elicit unbiased reports. Auditors are paid by the companies they audit and thus depend on CEOs and CFOs, who effectively decide on their employment and compensation. This creates an inherent conflict of interest that is endemic to the relation between the clients – management (the principal) and the auditor (the agent).

Are Auditors Independent?

The perception of the auditor's conflict of interest (lack of independence) started with a host of high profile, highly publicized corporate failures and near failures, the Enrons, Worldcoms etc. Among the (probably false) premises for the culpability of the auditor was the belief that the problem could have been avoided had not the

[1] 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 50 a year in the early 1990s to well over 200 a year in 2001.

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