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Discussant's Response to "The Acme Financial Statement Insurance Company Inc.: A Case Study"

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Before commenting on the Acme Case, it is useful to summarize the basic arguments Steve Aldersley makes in his paper, as I understand it.

Summary of Main Arguments

- The legal liability costs incurred by auditors are becoming so onerous – at least 11 percent of revenues and growing – that the business may soon become uneconomic. That is, the supply price will exceed the maximum amount buyers are willing to pay at all possible market quantities of the service.
- While auditors are doing good work – Steve cites evidence on the relative frequency of litigation developed by Palmrose (1988) – they are constantly being harassed in court to demonstrate their due diligence (lack of ordinary negligence). Auditors find this annoying.
- In addition, courts are seemingly holding auditors liable even in cases where residual audit risk has been reduced to an acceptably low level. That is, although reasonable assurance that the financial statements are free of material misstatement has been obtained, auditors are often held liable for losses suffered by investors, creditors, etc. In effect, courts are imposing *de facto* strict liability on auditors (i.e. demonstrating due diligence is no defense).
- Given this state of affairs, it would be better for all concerned if the "rules of the game" were clarified by acknowledging that auditors are really selling an insurance policy indemnifying financial statement users against losses incurred on account of reliance on materially misleading financial information.
- Therefore, let's set up a business form – an insurance company – which can:
  1. Contract with (somebody) to offer such insurance.
  2. Only insure against losses arising from unintentional financial statement errors as the base case, with policy riders available to cover misstatements arising from management fraud and/or business failure (inadequate disclosure, etc. of a business's going concern problems).
  3. Set specific policy limits (a liability cap).
- Finally, the paper seems to suggest that this insurance company will probably undercut the prices charged by public accounting firms and drive them out of business.

Overall Reaction

My initial reaction on reading Steve's paper was that the Acme Financial Statement Insurance Company was as much (perhaps more) a public accounting firm than an insurance company. That is, it could not set an appropriate insurance premium without performing an extensive investigation of the "client's" accounting system and financial statement assertions (more on this point later). The major difference, it seems to me, is that Acme is strictly liable for losses, while at the same time Acme can "pick

and choose" *what* it is liable for (source of material misstatement), *how much* it is liable for, and *to whom* it is liable. These are all luxuries not currently available to auditors!

Also, I was surprised that Steve limits the insurance to losses suffered on account of reliance on materially misstated financial statements. This does not seem to get at a major problem facing auditors in court: plaintiffs are often just trying to recover their investment losses even when the financial statements were not materially misstated at the time they were prepared, but may look questionable in hindsight after a business failure, the collapse of real estate values, etc. Auditors currently face this litigation problem, and so would Acme!

Turning to specifics, I have three major comments (with several related observations) on the paper, and a final personal observation on the auditor "litigation crisis" including the implausible economics which seems to characterize much of the discussion of that issue.

Comment 1: Acme is as much an auditing firm as an insurance company. It must perform the equivalent of an audit to set an appropriate premium.

This comment simply reflects the fact that a strictly liable insurer (auditor) would be motivated to expend some effort (incurring the costs of resources utilized) to determine a probability that the financial statements were materially misstated. The basic trade-off is the familiar one: more audit effort reduces the expected insurance payout (liability losses). Assuming an upward sloping "total cost of effort" function, and a downward sloping "expected payout" function, it is likely that some non-zero effort level minimizes Acme's expected costs. This is the efficient (minimum) insurance premium, given the risks faced. It is in Acme's self-interest to do the work, or risk losing the business to a competitor insurance company (auditor).

Note that if generally accepted auditing standards (GAAS) are such that this expected cost minimizing effort level constitutes a GAAS audit, then an auditor operating in competition with Acme in the existing legal environment (and other things held constant) could probably undercut Acme's price. This is because such an auditor need not charge a risk premium to cover the possibility that even though reasonable assurance has been obtained, the financial statements are actually materially misstated (audit risk). Thus, taken alone, the move to strict liability is cost-increasing, unless the courts are very inefficient in allowing auditors to establish a due diligence defense. But with strict liability, there is also the added cost of estimating an appropriate premium to cover the residual risk.

However, I don't think it is really possible to compare Acme's fees with today's audit fees. There is a major "apples vs. oranges" problem since real-world auditors are not able to pick and choose the nature of misstatements they are expected to uncover, they largely do not determine the specific parties to whom they are liable, and they do not operate with liability caps. Thus the products sold by today's auditors and Acme are not comparable.

Finally, while the importance of GAAS is clearly reduced in an insurance (strict liability) regime – since compliance with GAAS does not constitute a legal defense – there is still a role for technical professional standards in guiding the performance of an effective and efficient audit. Thus, I don't fully agree with Steve's claim on p.106 that "auditing standards are not relevant" to Acme.

Comment 2: There are many important incentive effects if (certain) financial statement users are insured against losses from material financial statement mis-

statements, and there is no other legal liability regime nor mandatory audit requirement in place. *(Steve's paper does not discuss these problems.)*

A major concern is that financial statement users who are insured against losses have no incentive to exercise reasonable care in relying on financial statements in making decisions. For example, a creditor may be motivated to place too much weight on financial statement information rather than other important characteristics of potential borrowers. Shavell (1980) showed that strict liability without a defense of contributory negligence is inefficient (wasteful of resources) because victims do not have an incentive to be careful in using a product or service. While a contributory negligence defense would presumably not be available to an insurance company, perhaps co-insurance provisions could be used to deal with the problem.

Problems also arise with management's incentives in an insurance regime. Even with a basic policy (coverage for unintentional errors only) management's incentive to maintain a well functioning internal control system is reduced, since the company is indemnified against losses suffered by "outsiders" on account of such errors. This affects the probability of error, the extent of the necessary "underwriting investigation" (the audit), and the appropriate premium.

Offering policy extensions to cover material misstatements arising from management fraud and/or business failure would likely create serious adverse selection problems – the offer of insurance will tend to attract the worst risks. Moreover, there are potential moral hazard problems in that the insurance may encourage more management fraud, and/or encourage management to undertake more risky investments – increasing the risk of business failure. The equilibrium level of audit effort and the appropriate insurance premium would be very difficult to determine in these circumstances.

Related to the previous point, changing from a mandatory audit regime to a voluntary contractual regime can be expected to change the nature of the "risk pool" facing insurers. Given the information asymmetry between insurers and management – management knows a lot more than Acme about its accounting systems and internal controls, its incentive to commit fraud and prospects for business failure – it is not clear how, if at all, the market would function. For example, if ethical viable companies were unable to convince insurers of their true type, the premium could be too high to induce them to purchase insurance voluntarily and the market could unravel (Akerloff 1970).

Finally, I assume Steve's insurance proposal entails a recision of the mandatory audit requirement. Presumably, this legal requirement arose because there are public good aspects of the audit service. That is, users of audited financial statements can benefit from the reduction in risk of material misstatement without affecting the use (consumption) of other financial statement users. Under a voluntary insurance scheme, there would presumably be a class of uninsured current or prospective shareholders, creditors, etc. who potentially benefit from the risk reducing aspects of an underwriting investigation (audit). These benefits are ignored in setting the terms of Acme's insurance contracts, resulting in a potential undersupply of the service.

Comment 3: There are a number of ambiguities in the Acme business plan.

Some of the more serious issues are:

- It is not entirely clear to me who would actually purchase the insurance and pay the premium – a company or specific financial statement users? If policies were sold to companies, how would the changing identities of stakeholders (share-

holders, creditors, etc.) be dealt with? If policies were sold directly to financial statement users, what incentive does a company have to submit to an "underwriting investigation"?

- When making a claim, how can users establish that a material misstatement has occurred without detail investigation of company records? It seems that the claims process could easily degenerate into extensive litigation. Moreover, the distinction between unintentional and intentional misstatements is not very clear when the application of accounting principles and disclosure judgements are at issue. Again, there is scope for litigation.
- With a prior probability of 60 percent that material misstatements exist in financial statements and a likelihood of detection of 90 percent, the Bayesian posterior probability of undetected material misstatements in "audited" financial statements is about 13 percent (assuming α-risk is zero), not the six percent used by Steve.

Concluding Comments

Steve has chosen an unusual way to address a complex social policy question: What is the welfare maximizing liability regime for auditors? Essentially he asks: Could a private company which provided insurance to certain parties in certain amounts in certain circumstances for losses suffered on account of what we now call "audit risk" (1– reasonable assurance) successfully compete against traditional public accounting firms? Unfortunately, I have no idea what the answer would be because there are just too many differences between the current regime and the proposed business, and the institutional background within which Acme would operate is unclear to me.

A more tractable question would be: Is strict liability preferable to a negligence regime? Shavell's analysis suggests the answer is generally, *No.* Moreover, using an experimental markets approach to compare strict auditor liability vs. negligence, Dopuch and King (1992) found that audit fees were so high under strict liability that auditors were frequently not hired, with potential auditees finding it preferable to restrict their investment plans because they were unable to convince potential shareholders of the value of those investments.

This raises the interesting issue that perhaps the major problem is not litigation itself, but the difficulties auditors have in pricing their services given the uncertainties arising in a litigious world. I find the argument made by Steve in the introductory parts of his paper that we should expect liability losses as a percentage of CPA firms' revenues to continue to grow until the firms are bankrupt, implausible.

The mandatory audit requirement for SEC registrants tends to make aggregate demand highly price inelastic, facilitating the "pass through" of auditors' costs. Moreover, I know of no evidence that audit firm partners earn less than a normal return on their invested human and financial capital. They probably earn a lower return than they would like (who doesn't?) and some might have earned more in the less competitive and less litigious past. But none of this portends the bankruptcy of the industry.

It seems to me that the problems of pricing audit services when catastrophic events can occur with very low probability is an interesting and important research issue. But the evidence from Dopuch and King's work seems to suggest that it is much more difficult to assess the expected cost of, hence properly price, a service under strict liability (a complex premium) than under a negligence regime (mostly labor costs).

Voluntarily assuming strict liability, even under the guise of insurance, does not seem to be the best cure for auditors' litigation and pricing problems!

To conclude, I found Steve's paper both interesting and thought provoking, and appreciate the opportunity to discuss it both at the Symposium and in these written remarks.

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