University of Mississippi

eGrove

Proceedings of the University of Kansas Symposium on Auditing Problems

Deloitte Collection

1-1-1994

Acme Financial Statement Insurance Company Inc.: A case study

Stephen J. Aldersley

Follow this and additional works at: https://egrove.olemiss.edu/dl_proceedings

Part of the Accounting Commons, and the Taxation Commons

Recommended Citation

Auditing Symposium XII: Proceedings of the 1994 Deloitte & Touche/University of Kansas Symposium on Auditing Problems, pp. 094-108;

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Proceedings of the University of Kansas Symposium on Auditing Problems by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.

5

The Acme Financial Statement Insurance Company Inc.: A Case Study

Stephen J. Aldersley
Ernst & Young (Canada)

Prologue

At the 1992 Kansas Symposium I made some serious judgmental errors, particularly during the discussion of Jerry Sullivan's article on Litigation Risk Broadly Considered. I made the silly observation that in this quagmire of auditor litigation, there was a business opportunity. It seemed to me that the auditing profession was running an insurance business while not really having any idea as to what the loss ratio was. Why not form an insurance company to offer financial statement insurance rather than audit opinions? After all, the market seemed to want someone to pay for their losses and the auditor was apparently the only party left with any money in a financial failure.

It seems when I open my mouth I often get something caught in it. Almost a year ago, Raj Srivastava asked me to develop the idea more formally and present it at the 1994 Symposium. I accepted the invitation. So much for common sense. Well, here is the result of that analysis, a case study built around a business plan for a financial statement insurance company.

If one considers the number of audits performed on an annual basis, one can only conclude that auditors actually make very few mistakes. In fact, as reported by Palmrose (1988) in her studies of auditor litigation the actual rate at which auditors fail in such way as to cause financial loss is extremely low, much less than one percent of the time. Notwithstanding this remarkable performance, the costs of auditor litigation, including direct payments, legal costs, and liability insurance premiums (when available), have risen to amounts that are now very significant costs for public accounting firms. As reported by Mednick in a speech at the American Accounting Association's 1993 Annual Meeting, the litigation costs of major U.S. auditing firms have risen to 11 percent of revenues in 1992 and continues to trend upward. This cost does not include the costs that are being added to each and every audit as audit firms react to the increasing exposure by seeking increasingly burdensome auditing standards and by following defensive auditing strategies.

Should auditor legal costs continue to grow, it will probably not be long before auditing becomes uneconomic. What will evolve to replace the existing framework? Before attempting to answer that question, it is important to recognize that the current litigation environment and the public's expectation of auditors do not exist in a vacuum but as part of society's evolution. In the past, auditor litigation often led the evolution of the audit both in technical terms but more importantly in terms of what should be expected of an audit. While the auditing profession's attempts at bridging the *expectation gap* are highly worthwhile, they may reveal a more fundamental issue, and that may be a need that the existing framework cannot satisfy.

The objective of this paper is to explore the possibility that society's evolving needs with respect to the reliability of financial statement information may require extending the audit framework and possibly abolishing the existing model and turning to something quite different. The idea of an insurance model for auditing is not new. For example, auditing firms have always considered their business risk in an audit engagement and many business processes and audit procedures are designed specifically to address those risks. However, these approaches do not go as far as viewing the audit as a form of insurance. Interestingly enough, Gunz and McCutcheon (1990) present an approach to the audit service that takes an insurance perspective but within the framework of the existing auditing firm model. Not surprisingly, many of the features of their proposal are quite similar to the insurance model that is developed in the case study below. But there are also some important distinctions in moving to a full insurance model.

The case study is organized in the form of a business plan for a financial statement insurance company, and therefore, includes discussion of the market for the service, how it could be sold, the product itself, how such a company might be expected to operate and what the financial consequences might be. The paper concludes with a brief review of some of the characteristic features of an insurance approach to enhancing financial statement credibility.

Acme Financial Statement Insurance Company Inc.: Business Plan 2001

The Company

The Acme Financial Statement Insurance Company, which was founded in 1999, has its head office in Litigant City, Somestate, USA and is the first insurance company of its kind in the world.

Acme's Business

Acme specializes in providing financial statement insurance. Companies that distribute their financial statements to the public or to specified third parties purchase a financial statement insurance policy in order to compensate users of the financial statements who suffer economic losses as a result of errors or misstatements in the distributed financial statements.

Acme's Distinctive Competencies

Acme is the first organization to offer financial statement insurance and is the first organization to apply insurance principles to enhancing the reliability of financial statements. The company plans to develop extensive databases on individuals, businesses, industries and financial information systems that is used as a basis for underwriting companies' financial statement risks. The company has superior investigative, investment analysis, claims handling, and financial skills drawn from several disciplines that operate in a coordinated way to ensure that unacceptable risks are declined, acceptable risks are accurately priced, legitimate claims are handled quickly and as fairly as possible and unwarranted claims are vigorously contested.

Market Analysis

The Market for Financial Statement Insurance and Outlook

Companies and other organizations that publicly distribute financial statements prepared in accordance with the requirements of the Financial Accounting Standards

Board often need to enhance the reliability of the information in those financial statements. This is particularly valuable when the information is provided to the public or to third parties such as banks and key ownership interests. Such users of the financial information can be expected to make financial decisions based on the information and therefore run a risk of financial loss in the event the financial information is incorrect or misleading. In the case of SEC registrants, such reliability enhancement is a requirement of registration.

Target Markets

Although our target market is ultimately all users of financial statements and related information, our initial target market will be non-public entities where the financial statements are provided to specified third parties. We will expand our operations once we have a firmly established base in this market segment. We believe there is significant potential in the public marketplace but recognize there will be a need to establish the product in a situation where we have direct access to financial statement users.

Competition

The dominant providers of reliability enhancement today are the public accounting firms, professional partnerships of CPA's who issue audit opinions on company and organization financial statements.

Audit opinions are professional opinions on the conformance of financial statements with generally accepted accounting principles as promulgated by the FASB and its predecessors. These opinions are based on audit examinations which are performed in accordance with what the accounting profession calls generally accepted auditing standards. According to the profession, an auditor's responsibility is to perform the audit examination in accordance with these standards and if this is the case, the auditor has no further obligation with respect to the examination.

Audited financial statements may contain errors or omissions that may be material and yet are not detected by the auditor. If the financial statement user incurs a loss as a result of relying on incorrect financial statements, there will be no recourse to the auditor if generally accepted auditing standards have been applied in the audit examination. The only hope for recovery from the auditor is through negligence actions which dispute the assertion that generally accepted auditing standards have been applied, except in certain cases where the auditor has statutory liabilities.

From the user perspective, this situation appears to be somewhat unsatisfactory. Although in practical terms, the auditor faces a difficult and often expensive task in proving that generally accepted auditing standards were applied in a particular audit engagement, the user must commit substantial time and resources to force the situation and must accept a significant risk of failure.

In the short run, the accounting profession will be a very strong competitor, particularly on price. However, in the longer term, price will not be successful. Accounting firms carry significant labor costs associated with the need to perform their examinations in accordance with generally accepted auditing standards.

Regulatory Restrictions

Acme is an insurance company registered in Somestate and is therefore bound by the requirements of the Somestate Insurance Law. These requirements limit the nature of operations and force the company to maintain a strong capital position relative to its insurance liabilities.

Marketing and Sales Activities

Overall Marketing Strategy

Acme's overall marketing strategy is a direct approach to the market. Existing insurance brokerage operations do not yet have experience with financial statement insurance, and therefore, it will be necessary for Acme to market directly using personal and non-personal methods. Our marketing focus will be on third party users of financial statements in our primary target market. These users will include bankers, pension funds, investment dealers and other investment operations. This strategy recognizes that such users are generally more accessible and likely to be more receptive to our sales approach than the companies whose financial statements we will be insuring.

We will also develop direct mail and a targeted advertising campaign, also focusing on third party users of financial information.

Sales Strategies

We will develop a full and part-time sales force who will call on potential third parties. The benefits of financial statement insurance, particularly the direct compensation for financial loss and the no hassle approach to claims handling are compelling reasons for these users to demand insurance over audit opinions.

Calls and inquiries arising from our direct mail and advertising campaigns will receive calls from our sales force to determine if personal follow up is worthwhile. Although our primary focus will be on third party users, we fully intend to follow up with companies and organizations that prepare financial statements if they respond to inquiries.

Product/Service

Financial statement insurance is a unique product. It is fundamentally an insurance product in that it is a contractual promise to pay a certain amount to a specified party in the event that party suffers a loss as a result of the occurrence of certain specified events.

The Financial Statement Insurance Policy

The key components of the financial statement insurance policy are the following:

Insured

> The policy will clearly identify those parties, either corporate or individual, who are entitled to receive benefits in the event of a financial loss caused as a result of a financial statement error. Insureds may include, company management, company directors, common and preferred stockholders, holders of funded debt obligations, specified bankers and other lenders, and specified third parties such as purchasers and suppliers. In the latter cases, the policy should name the lender or third party explicitly.

Occurrences

> A financial statement insurance policy will pay a claim when the following two conditions have been satisfied:

1. The financial statements contain one or more errors or departures from generally accepted accounting principles that, in aggregate, are greater than a specified monetary amount (i.e., materiality), and
2. The insured can demonstrate that a loss has been suffered as a result of relying on the inaccurate financial statements.

   There will be several important exclusions in the standard policy. For example, management fraud that results in a deliberate misstatement in the financial statements will not be covered under the standard policy. Nor will the insurance cover financial statement errors arising from business or financial failure. Financial statements will normally be prepared on the going concern basis except in unusual situations. Policy extensions will be available to cover both of these exclusions from the standard policy, but at an additional premium.

Claims benefits

Insureds will be entitled to financial payments in the event of an "occurrence." The amount of the payment will be limited to the lesser of the insured's actual loss and the pro-rata share of the overall policy limit. In some cases, particular insureds may be entitled to unique policy limits which would be specified in a policy extension and therefore would not be subject to the pro-rata limitation. Payments under the policy will not be made until 60 days after the end of the policy term. This is necessary to ensure that all possible claims have been considered.

Policies will be issued with an explicit monetary overall policy limit that represents the maximum aggregate amount of claims benefits that would be paid under the policy. Aggregate losses in excess of this limit will not be covered. The policy contains benefit sharing percentages that are used to allocate benefit payments in the event the aggregate losses exceed the overall policy limit. In such a situation, an insured would receive at most the overall policy limit multiplied by that insured's benefit sharing percentage as defined in the insurance policy.

Policies can be written with a benefits redistribution clause that permits payments in excess of the insured's pro-rata share of the overall policy limit in cases where losses incurred by some groups of insureds are below their pro-rata limit. The excess limit would be shared pro-rata amongst the other insureds. This clause addresses the situation where one class of insureds, say lenders, do not suffer any loss whereas common stockholders do. Since it increases the insurer's exposure, there is obviously an incremental premium for this clause.

Premiums

The policy premium must be paid to activate the policy. Premiums will be based on underwriting criteria and will depend upon the risk rating of the particular entity financial statements, the materiality level chosen, the overall policy limits, the policy term and any other policy extensions or clauses that affect the insurance risk.

Policy Term

Policies issued on a set of financial statements will have a specific inforce term of up to three years from the date of the financial statements. Claims for losses suffered during this period are insurable provided the claims are submitted prior to the end of the policy term. Longer terms are expected to require significantly higher premiums than shorter terms and as a result, the normal situation will be a one-year term.

When an entity's financial statements are insured, there will be a Certificate of Insurance attached to the financial statements which alerts the users of the financial statements to the existence of the insurance policy. An illustrative Certificate is shown below:

Acme Financial Statement Insurance Company Inc.
Certificate of Insurance
X Co. Financial Statements
December 31, xxxx

The Acme Financial Statement Insurance Company Inc. has written financial statement insurance policy number 12345678 on the accompanying xxxx financial statements of X Co. This policy provides certain benefits to specified insured parties in the event these financial statements contain errors or departures from generally accepted accounting principles which in aggregate misstate the net income of X Co. for the year ended December 31, xxxx by more than $1,000,000 and the specified insured parties have suffered financial losses as a result. Claims for benefits under this policy must be submitted no later than December 31, xxxx+1.

This policy contains exclusions for deliberate misstatements by management and for subsequent financial failure of X Co.

The policy has an overall limit of $5,000,000 which applies pro-rata to the specified insured parties as outlined in the Schedule A of the policy documents.

This certificate does not constitute an insurance policy. Inquiries concerning the provisions of Policy Number 12345678 should be directed to Public Affairs Dept, X Co. Address and Telephone number.

Policy Development

We expect our initial policy offerings will undergo development as we gain experience with the needs of policyholders and insureds as well as the nature and magnitude of claims that arise.

Operations

Acme's operating structure will be similar to that of a specialty insurance company and will differ significantly from the operating structure typically found in public accounting firms.

Sales and Marketing

The sales force will consist of commissioned salespersons with specialized financial and insurance training. Sales force compensation will be based on commissions with adjustments for experience on the block of business handled by the salesperson.

For example, salespersons with blocks of business with excessive loss ratios will be paid reduced commissions whereas those with better than average loss ratios will receive bonuses. The salesperson benefits considerably from retaining clients that are good insurance risks.

The salesperson is the key customer contact and will be responsible for sourcing new business, negotiating insurance contracts, and day-to-day customer relations. The ideal salesperson will be a business generalist with a strong background in investment and financial analysis.

The marketing operation will use the sales force as a source of information on customer needs in order to develop new insurance and other products. Marketing will also take the leadership role in product innovation and development and manage multi-disciplinary teams with representation from sales, underwriting, claims and statistical and actuarial in order to develop new financial statement insurance products.

Underwriting

The objective of underwriting financial statement insurance is to first, distinguish those risks that are insurable from those that are not, and secondly, to properly rate the insurable risks so that an appropriate premium is charged.

We will use empirical methods to identify uninsurable situations and to develop rate tables for insurable situations. Existing market data will be used initially and this will be modified through experience.

The underwriting department will be multi-disciplinary with specialists in conducting private investigations, forensic accounting experts, systems experts, investment analysts, business operations specialists, and accounting experts. There will also be a group of technicians available for data collection. Where appropriate, industry specific experience and expertise will be used in the underwriting process.

The underwriting process begins with an initial screening of the potential customer by the salesperson. This includes inquiries regarding the customer's reputation and the integrity of key individuals in the customer organization. An initial assessment is made of the company's operations and degree of business success, as well as the management systems employed.

This initial underwriting phase is intended to identify clearly uninsurable customers such as those where the principals have questionable integrity, are incompetent, have hopelessly inadequate management systems, or are nearly bankrupt.

The initial screening is followed by a formal underwriting process that involves the following:

- A formal private investigation of key individuals including a credit check and a lifestyle analysis. This would be performed on all new customers and on a three year cycle for existing customers. Insurability is again assessed at this stage and a decision to proceed with further underwriting is made.
- An onsite investigation focusing on the business operations and management systems. This investigation is multi-disciplined and would normally include industry-specific experience. The objective is to identify risk areas in the operation that may lead to financial statement errors or misstatements. One result of this investigation will be the development of a specific investigation program to be conducted by underwriting technicians.
- Another assessment of insurability is made at this point in the process. At this time, a fixed non-refundable underwriting fee is agreed with the customer which

will be credited against the insurance premium should the customer buy a policy. The amount of this fee is set to cover the direct underwriting costs and is substantially lower than a typical audit fee.

- A detailed review of the accounting principles followed by the customer in preparing the financial statements is performed. Any and all errors and departures from generally accepted accounting principles identified would be considered in the underwriting decision. Inappropriate accounting principles would require adjustment.
- Conduct the specific investigation program. This may include typical audit procedures such as inventory count observation, tests of transactions, confirmation of certain items, etc. or possibly forensic investigation.
- Determine risk classification and rating.

Once the risk classification is determined, the salesperson negotiates the insurance contract details, including materiality, overall policy limit, policy term, policy insureds, and the premium. The premium is then collected and the insurance policy and certificate is issued.

Investments

Premiums received, after commissions and other acquisition costs, are invested to earn interest, dividends and capital gains. In view of the volatile nature of the insurance business, it would not be sensible to incur additional risks on the investment side of the business. Accordingly, a conservative investment strategy is planned with a focus on government bonds, high quality corporate bonds and preferred shares and blue chip common stocks. Our investment manager will adhere to a comprehensive set of investment guidelines so that risks in this area are minimized.

Claims

The objective of our claims operation is to ensure that all legitimate claims are handled fairly and promptly. To file a claim, the insured must describe the financial statement errors that misstate the financial statements and also provide proof of financial loss. When we are notified of a claim, the customer will be contacted and inquiries will be made to determine if a financial statement error has occurred. If it is concluded that an error is likely, an analysis will be conducted to determine the extent of the error and whether or not there are additional errors that may affect the financial statements.

If the net errors are material, then an evaluation of the proof of financial loss is conducted and the payment amount for the insured is determined. All payment amounts are accumulated and any policy limitations are applied before claims payments are made. The claims department uses forensic accounting specialists to perform the investigations and will also include lawyers on staff.

Statistical and Actuarial

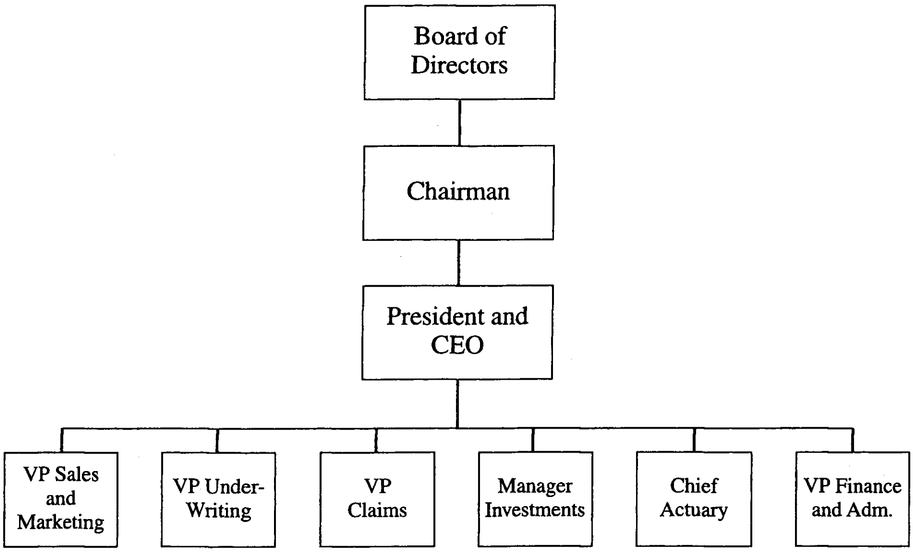
As claims data accumulates, it will be analyzed to identify patterns and other characteristics. The objective is to provide information that would assist the underwriting department in setting rates. In addition to the analytical responsibilities, the Statistical and Actuarial department is responsible for determining reserves for Incurred But Not Reported claims, claims development and the adequacy of statutory reserves for unpaid claims. The department will be staffed primarily by casualty actuaries and statisticians with financial experience and training.

Finance and Administration

The administration of the company will follow the usual structure with a support staff to administer finance, personnel, information systems, and general corporate activities.

Management and Ownership

Organization Chart



Acme's Legal Structure and Ownership

Acme is a widely held public insurance company. It is registered with the Somestate Commissioner of Insurance and has a licence to operate in all fifty states and in Canada.

Financial Projections and Capital Requirements

Projected Financial Data

The following table presents the projected financial results for Acme for the next five years. Key assumptions used in developing these projections are discussed below. Dollar amounts are in millions.

	Jan 1 xxxx	xxxx	xxxx+1	xxxx+2	xxxx+3	xxxx+4
Written Premiums		1000	1100	1250	1400	1600
Earned Premiums		500	1050	1175	1325	1500
Claims incurred		345	735	846	954	1050
Claims expenses		15	32	35	40	45
Underwriting		100	189	176	199	225
Commissions		50	105	118	133	150
Other expenses		60	84	82	80	90
		570	1145	1257	1405	1560
Insurance income		(70)	(95)	(82)	(80)	(60)
Operating ratio		114.0%	109.0%	107.0%	106.0%	104.0%
Investment income		79	147	184	210	238
		9	52	102	130	178
Taxes		4	21	41	52	71
Net income		**6**	**31**	**61**	**78**	**107**
Return on average equity		0.7%	3.7%	6.5%	7.3%	8.5%
Investments	360	1226	1714	1964	2230	2538
Fixed assets	40	40	40	40	40	40
Total assets	**400**	**1266**	**1754**	**2004**	**2270**	**2578**
Unearned premium		500	550	625	700	800
Unpaid claims		360	767	881	994	1095
	0	860	1317	1506	1694	1895
Capital	400	406	437	498	576	683
Risk ratio		2.5	2.5	2.5	2.4	2.3
Total liability and capital	400	1266	1754	2004	2270	2578
Assumptions						
Net loss ratio		69%	70%	72%	72%	70%
Claims expense ratio		3%	3%	3%	3%	3%
Commissions rate		10%	10%	10%	10%	10%
Underwriting exp		20%	18%	15%	15%	15%
Other expense		12%	8%	7%	6%	6%
Investment return		10%	10%	10%	10%	10%
Tax rate		40%	40%	40%	40%	40%

Projected Loss Ratio and other Significant Assumptions

The most significant assumption in projecting financial results is the loss ratio. A long term loss ratio of 72 percent with small fluctuations has been used in the above projections.

The loss ratio can be controlled through varying the premium level against the overall policy limits and the materiality level. The underwriting process itself can also affect the loss ratio in this case as it may identify financial statement errors prior to finalizing the financial statements. The underlying frequency of material error in financial statements is the key factor in setting loss ratios.

Over time, experience will provide Acme with a fairly accurate estimate of the frequency of material error. Furthermore, that information will be in sufficient detail so that frequency levels can be classified by the different types of entities that will be insured. Initially, however, it will be necessary to make a blanket assumption. An analysis by Kinney and Martin (1993) of audit-related adjustments across a 15 year period and over 1,500 audits indicates that material errors are detected in from 20 percent to 60 percent of the audits. On this basis, we propose to use an underlying frequency assumption of 60 percent. This means that we will assume that any set of financial statements of an insurable customer will have an inherent 60 percent probability of a material error before any formal underwriting is conducted.

We anticipate that underwriting will identify the material errors in 90 percent of the situations where material errors exist and therefore our net frequency of material error should be no more than six percent. It is further expected that claims payments will be equal to roughly 12 times the premium which gives the 72 percent loss ratio.

Although payments will only be made in the event of financial loss by insureds, we have used a conservative assumption that claims payments will be made in 100 percent of the cases where there is a material financial statement error. Emerging experience will be used to provide a more accurate estimate.

Other assumptions used in the projections are set as follows:

Claims expense ratio

> This has been set at three percent of earned premiums on the basis that there is considerable information available from the underwriting process. It relates entirely to the time spent by internal personnel on handling claims.

Commissions rate

> Set at ten percent of premiums.

Underwriting exp

> Initially set at 20 percent of premiums to reflect the learning curve and the development of a database of experience. It is expected to drop as this database develops. It is roughly equivalent to a large portion of the salary costs of a public accounting firm.

Other expense

> A guess. Again, there should be some start-up costs that will eventually disappear.

Indicated Capital Requirements

Initial capital has been set at $400 million which gives an underwriting capacity of roughly $1 billion if we allow a 2.5 to 1 underwriting ratio. The above projections indicate the capacity for ten percent growth in written premiums on an annual basis. There should also be some margin available for dividends.

Epilogue

It is instructive to compare the insurance model with the existing attestation framework. The following table outlines some of the significant differences in the features between an attestation service and an insurance model.

Feature	Attestation Framework	Insurance Model
Product or service	Audit opinion – a professional judgment	Insurance policy – a contractual obligation
Product features	Claims viewed as challenges to auditor reputation	Objective is to pay legitimate claims – *failure* to pay affects reputation
Nature of liability	Based on negligence laws	Based on insurance contract
Who can seek compensation	Duty of care doctrine – determined by common law	Specific insured parties as stated in the policy
Amount of compensation	Essentially unlimited – dependent on losses sustained	Contractually limited to a fixed amount
Period of exposure	Essentially unlimited, although limited by statements of subsequent periods	Limited to policy term
Key success factor	Adherence to professional standards	Effective underwriting and claims handling – auditing standards not relevant
Relationship with customer	Must be independent	Independence unnecessary
Pricing	Based primarily on time spent which is related to the risk – often fixed in advance	Based on insurance risk – determined by underwriting process
Role of judgment	An integral part of the audit process with pervasive effect	A similar role to auditing – important to underwriting
Operating structure	Professional training environment with focus on accounting and auditing	Specialists in diverse fields with analytical approach to business

While there are important structural differences between the two models, perhaps the single most significant difference is the attempt to replace tort law liability with a contractual form of liability. In many respects, this is essentially a return to the role of auditing at the turn of the century. Time is not reversible however, and the price that must be paid for this return to a contractual liability exposure is a willingness to pay claims when there are errors in financial statements, something auditors would have considerable difficulty with.

Is financial statement insurance a viable product? There does not seem to be any reason why insurance companies could not provide a similar form of insurance today. For example, fidelity bonding companies provide a form of loss coverage in the event of fraud and one could argue that insurers of auditor liability provide something similar at the present time. But there does not seem to be anything on the market that is in essence a financial statement insurance product, other than audits. There are several possible reasons for this:

Legal
: Audits are often required by statutes such as corporations acts and securities laws and it would be difficult to alter this historical structure. For example, the benefits of financial statement insurance would have to be clearly demonstrated before the SEC would find such arrangements an alternative to audits.

Economics
: Financial statement insurance may not be economically viable as it may be too expensive. If one factors in all of the costs including loss ratio, etc. and this leads to a premium that is higher than would be spent on a conventional audit, it will be difficult to economically justify an insurance operation. If this is the case, there are some serious implications for the existing auditing framework.

Claims exposure
: While one might attempt to limit the exposure through carefully worded insurance contracts, it is quite possible that almost every insurance policy will attract a claim on the basis there is nothing for the plaintiff to lose. This would add significantly to claims handling costs until the contractual provisions were enforced by the courts.

While one could continue to explore the nuances of financial statement insurance, this would take us away from our objective. The issue is whether the existing auditing framework still meets society's needs for enhancing the credibility of financial reporting at an economically viable cost. The case study provides an interesting alternative which has the added benefit of exposing some of the serious difficulties with the audit model. There can be no doubt that if litigation costs continue to escalate, this paper will become academic in a very real sense. Should the current growth rate in litigation costs continue for a five year period, litigation costs of the order of 30 percent of revenues will be the norm for accounting firms. We will then have a perverse form of financial statement insurance but have it provided by organizations that are not structured for that particular product. We may have the opportunity to witness a short term phenomenon.

Before this apocalypse occurs the profession must revisit some fundamental issues. We cannot afford to misinterpret an expectation gap as a failure to communicate the auditor's role. Is the rise in litigation a message to the profession that its existing product is no longer suitable? We need to explore what society needs and obtain a clear understanding of what they are asking for. The concept of financial statement insurance is one example of an alternative product that can be used to more accurately frame society's expectations of our profession. We need to listen. But we must also educate and inform.

References

Sullivan, J. D. 1992. Litigation Risk Broadly Considered. *Proceedings of the 1992 Deloitte & Touche University of Kansas Symposium on Auditing Problems.*

Palmrose, Z. V. 1988. An Analysis of Auditor Litigation and Audit Service Quality. *The Accounting Review,* Vol. LXIII, No.1 (January): 44-73.

Gunz, S. and McCutcheon, J. 1990. An Alternative Perspective on the Role of the Audit. Unpublished Working Paper, Wilfrid Laurier University.

Kinney, W. R. and Martin, R. D. 1994. Does Auditing Reduce Bias in Financial Reporting? A Review of Audit-related Adjustment Studies. *Auditing: A Journal of Practice & Theory*, 13 (Spring): 149-156.

Acknowledgments

I would like to thank Sally Gunz, Zoe-Vonna Palmrose, and Bill Kinney for various discussions on auditor litigation issues and for providing copies of some unpublished work. I would also like to thank Graham Cudlipp and David Selley for their helpful comments on an earlier draft of this paper.