Communication of companies with their surroundings - the manipulation of information and information asymmetry

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- the manipulation of information and information asymmetry

Creative accounting, the bankruptcy of many companies, and ongoing litigations made rapid rebuilding of investor relations imperative. Growing importance of institutional investors, who have high information needs, also impacted this process. Thus, the needs for communication with investors and reducing information asymmetry problems have become key issues in the capital markets. The traditional model of reporting was based largely on information relating to past events (financial accounting). Commonly, there was inadequate consideration of non-financial information impacting the development of goodwill in the future. Some information was published with considerable delay. This facilitated the use of confidential information by those who had previous access to it.

The timely disclosure of full information enables investors to determine the intrinsic value of the company. It also allows determining the impact of different decisions on changes in cash flow, or changes in the value of firms. Disclosure is also important at a macro level, contributing to the integrity of capital market and its development. Transparency enhances confidence in the market and, consequently, capital flowing to equity markets or debt markets makes adequate assessment of the economy possible. Disclosure and transparency influence not only the business performance and valuation of individual companies, but also the ability of economies to attract national and foreign investment.

The big problem is the lack of comparability of data due to different accounting standards between countries. For many years there has been a tendency to harmonize reporting rules (IAS, IFFS) aimed at increasing market transparency and comparability of data. Introducing
international accounting standards, however, does not fully solve these problems. All this leads to a variety of gaps in reporting:

- qualitative gap – the executive board of a company considers a given factor to be an important generator of value, but the existing internal reporting systems do not provide adequate information to enable them to reliably assess its impact;
- reporting gap – the executive board of a company considers a given factor to be an important generator of value, but decides not to publish it;
- information gap - the shareholders of a company consider a given factor to be an important generator of value, but think that the company does not take it into consideration in reporting to a satisfactory degree.

Aggressive incentive systems and the greed of managers resulted in that all their actions were targeted at the rapid growth of the price of shares. This was attempted by various methods. Stock prices, as already mentioned, are very sensitive to information transmitted. Managers know this and often manipulate information. Various "visionaries" who are employed in top positions, well mastered the art of using information to shape the share price. This ability has become more important than building a sound strategy or a multi-annual plan of activities. With regard to disclosure and transparency, therefore, much remains to be done.

The role of investment advisers

As previously mentioned, access to information and methods of using it are the key factors determining the efficiency of the market. The same information is likely to be differently interpreted and used by inexperienced investors and by investment advisers. It is therefore important to determine the role played by investment advisers. Shiller said that there are two types of investors. The first group of investors reacts to information noise, with an exaggerated tendency to respond to any current message. The second group is called smart capital, investing on the basis of its assessment of the value of shares. Among the advisers different reactions to information may be observed as well.

The majority of investment funds participants use the services of professional investment advisers. The Investment Company Institute research shows that 59% of investors benefit from such advice. Recommendations relate mainly to the choice of one of many funds. The average investor meets with an advisor four times per year. Before making investment decisions investors verify the information on the fund and its co-owners; they take into account mainly the particular
risk, returns, reputation of the co-owners (sponsors), the investment objectives, and type of enterprises in which the fund invests most. Less important are qualifications of fund managers and scope of services the fund provides. When deciding on the choice of fund investors mainly use three sources of information. The first are financial advisers, the second - articles in the media, and the third - prospectuses and reports prepared by individual funds. The vast majority of investors monitor their fund shares. They largely control the net asset value per their account, the rate of return, stock prices, economic situation and level of risk of the fund. Individual account statements and reports of funds are the main sources of information. Fund rankings published in the press are also important for these investors.

Approximately 52% of investors take decisions independently. They benefit mainly from press releases and prospectuses of funds. The second group consists of investors often using services of investment advisers, which are usually brokers. This group includes older people with higher income and higher assets. They keep their money in more funds. The third group consists of passive investors. They are the least experienced and fully rely on the advice of financial advisers, friends and family. About 38% of investors belong to this group.

Investors who have used the services of consultants, usually agreed with their views. The degree of agreement was dependent on the role performed by the advisor. The biggest compliance occurred, when investors delegated all their powers to investment advisers. Investors took the views of the banks into consideration to a much lesser extent.

![Chart 21. Acceptation of advisers’ recommendations by investors in U.S., (%)](chart.png)

Financial advisers help inexperienced investors make the right decision or devote themselves only to technical aspects of the transaction. More often than not their activities concentrate on investment advice, portfolio management, and providing customers with information needed to make a decision. The vast majority of investors surveyed were satisfied with their advisers. Use of investment advisers who are better equipped to make decisions, have better access to information, and greater possibilities of their processing, increases market efficiency. Estimates made by a large number of independent analysts and advisers make the market as a whole more efficient in determining the "fair" value of shares. However, there is significant risk that the investment advisers, as well as managers, in pursuit of their own profits will advise customers in a way permitting them to achieve benefits even at the expense of their clients. The introduction of adequate controls may reduce this risk. So far, regulations in many countries mainly related to the verification of their qualifications (licensing) and to a smaller degree dealt with their responsibility for wrong decisions.

Recently, a very negative role was played by advisers employed by banks, who persuaded customers to borrow, including those clients who would not normally be eligible for credit under any circumstances (NINJA loans, clients were not creditworthy or would soon cease to be). Bank advisors do not sell products that would best suit the customer, but rather those on which they can earn the highest commission. Generally speaking, advisers earn their bread when they convince the customer to make decisions, and not when they discourage a client from deciding. From the perspective of shareholders' interest, however, this latter situation would be very desirable.

In summary, it can be stated that many decisions are made solely by, or with significant participation of investment advisers. As portfolio management and investing of mutual funds assets can be done only by licensed advisers, their role in the development of the market is very large. This may indeed help to increase market efficiency, if we manage to reduce the risk of various abuses.

The role of credit rating in the process of raising capital

The rapidly evolving situation in financial markets, financial crises, and bankruptcies of companies increases the need for information about issuers of securities (countries, companies). In order to raise capital obtaining a rating, or appraisal of financial situation, is often necessary. This assessment is granted by independent, reputable rating agencies. It allows an assessment of
investment risk associated with the company. This is especially important for those investors who do not have their own analytical departments. Various forms of bank risk transfer often made banks increasingly reliant on opinions of rating agencies, and they ceased to directly monitor borrowers.

Credit rating agencies are investment advisory firms involved with the assessment of the quality of securities. They analyse the issuer's financial situation, the details of the issue, etc. The activities of these agencies enhance the security of transactions on the capital market. The rating obtained affects the cost of raising capital, and influences business negotiations. It provides greater access to capital markets. Institutional investors are reluctant to invest in entities with low creditworthiness. Companies and entire countries are subject to such ratings. A country’s rating has an impact on conditions of raising capital by companies that have their seat in this country.

In the process of granting a rating quantitative and qualitative analysis methods are used. Assessment of the ability of companies to service debt on time (fundamental analysis) is carried out. Historical performance and forecasts for coming years are studied. Sensitivity analysis and scenario testing is performed. The prospects for the industry sector, competition, changes in demand, and their impact on the economic situation of the rated entity are all analysed. Analysis of changes in the business environment, assessments of the quality of management, implemented strategy, corporate governance, are performed in assessing the risks taken. Credit rating agencies do not perform audits of financial statements, but usually verify the accounting principles adopted, the method of consolidating statements or valuation of individual assets. Whenever different accounting systems are used, adjustments are made to ensure comparability of data. In assessing the financial position analysis of profitability and liquidity plays a key role. Cash flows from various activities are subject to detailed scrutiny.

The higher the probability of obtaining the expected stream of dividends and increasing profits is, and the better the company’s financial situation, the higher the rating. This rating is very important especially for players from those countries that have not been participants in international capital markets. The ratings allow investors to save time and money, and reduce the costs of agency.

The first post-communist countries that have obtained an assessment of their creditworthiness from international rating agencies were Hungary and Czechoslovakia. In 1992, Moody's Investors Services has granted them a rating at a speculative level - Ba1. Poland for the first time received a rating in 1995, Moody's acknowledged Poland's investment-grade scores - Baa3, and other two agencies rated the country at a speculative level.
The increasing complexity of capital markets made detailed evaluations of individual types of funds and securities a necessity. The volatility of the funds is also assessed. This assessment deals with the sensitivity of investment funds with fixed income to changes in market conditions and risk related with it. The appraisal of volatility includes the sensitivity of funds to changes in interest rates, credit risk, diversification and concentration of investments, liquidity, leverage and other factors. As a result of this assessment categories going from S1 (the lowest sensitivity to changing market conditions) to S6 (highest sensitivity) are granted.

Fund management companies are also rated. The assessment of individual companies is affected by factors such as:
- previous results,
- variability
- design of portfolio
- quality of management,
- status of corporation
- investment process.

Compliance with the rules and sound management can result in a high likelihood of achieving long-term return rates and liquidity adequate to the risks involved; the results achieved in this case are better than the average for the sector.

Assessment of funds requires at least two years of data reflecting their activities. Funds that do not meet this criterion are subject to additional verification. The assessment is based on information provided by funds and information from other sources. Rating agencies do not audit information provided.

S&P rating agency, for instance, assesses about 600 fund management companies worldwide, with assets exceeding $ 200 billion. In Europe, it assesses 150 funds.

Rating is another tool for better assessment of investment projects. It contributes to market efficiency. Having adequate information, the rating agencies may determine the risk associated with a country or institution (bank, fund management company) and thus provide the investors with a tool to make the right choice.

Analysis of the crises in Asian countries has shown that countries affected by the crisis did not make reliable data available, which would have resulted in a lowering of the rating of these countries and led to an earlier reaction of investors. This could reduce the violence of the withdrawal of capital from these countries and mitigate the effects of the crisis.

The last crisis has raised doubts about the independence and impartiality of these agencies. They were accused of granting unmerited positive ratings to companies of dubious reputation and
of tolerating so-called creative accounting. The overly high ratings were supposed to help these companies raise resources from financial markets, and rating agencies in turn hoped to win new orders and revenue. In my view, there are no sufficient grounds to make such accusations. Incorrect ratings occurred, but rather the rated institutions, which provided inadequate information, should be blamed. Probably there were situations where rating agencies simply were mistaken or even corrupt. But it must be kept in mind that at the same time, investors, analysts, and auditors assessed the same entities. Globalisation of the stock exchanges means that investors worldwide trade the shares of the largest firms.

It is worth adding that rating agencies should not substitute assessments made by investors, especially professional assessments made by those institutions that can and should make them. Managers should not be exempt from liability based only on ratings.

Improper use of information - aggressive accounting and use of confidential information

Under conditions of rapidly developing capital markets, equity owners are becoming major consumers of financial statements. The task of accounting is to provide information enabling assessment of the ability of companies to generate future financial surpluses and revenue for investors. As mentioned earlier, information is an essential element of the decision-making process. It plays a special role in the stock market. This specificity is due to the possible impact of information on share prices. Expedient taking of decisions makes the difference between possible losses or profits. On the stock market, the struggle for fast access to current information never ends. Those who first receive it can respond more quickly (buy or sell shares) and achieve higher profits. If the message reached everyone at the same time, the profits would be divided between all investors. It is an altogether different question; whether all investors react to the same information in the same way, or rather make different uses of it. For the smooth functioning of capital markets, therefore, the overall availability of information and its accuracy is of paramount importance. Privileged position of investors in access to information has, from the stock market perspective, a similar meaning as a monopoly on the commodity markets. Those who make decisions, or managers, usually have the best access to information. In the capital markets a phenomenon, often called “Insider Trading”, i.e. the use of confidential information, is well known. In addition to company managers this also applies to brokerage houses, investment funds or officials. People managing someone else's resources, knowing beforehand of a planned major
investment which may affect the share price, may be tempted to make some trades on their own account\textsuperscript{vii}.

Another way of taking advantage of information is to provide incorrect, or outright false, information to the public. Investors often are not able to verify such information. And even if it is possible, the time needed for the verification may delay their response\textsuperscript{viii}. Investors engaged in, for example, short sales, use such dissemination of incorrect information.

In the second half of the 1990s share prices increased considerably. The remuneration of the managers began to consist primarily of stock options. This has caused a temptation to cook the books in order to increase the share price; it happened mostly in the United States. In Europe, stock options play a lesser role as a component of the remuneration of CEOs. Continuous efforts to improve performance and increase the value of the company when it was difficult to increase profits induced many managers simply to commit fraud. The most common scam is: use of confidential information (insider trading), non-disclosure of a part of expenses, artificial blowing up of revenues, and the use of special funds to artificially increase profits. One can often meet with the term "creative accounting". This is not a good name for an ordinary fraud. The concept of "aggressive accounting" could also raise some doubt, but such a concept is often found in economic literature. Aggressive accounting is primarily focused on artificially inflating profits, with the objective of achieving higher stock prices. Below are some examples of investigations conducted in 2002 by the American Securities and Exchange Commission:

Table 1. U.S. firms suspected of "aggressive accounting"

<table>
<thead>
<tr>
<th>Firm</th>
<th>Pleas</th>
<th>Auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adelphia</td>
<td>concealment of approximately $ 3.1 billion of loans and bank guarantees</td>
<td>Deloitte &amp; Touche</td>
</tr>
<tr>
<td>AOL Time Warner</td>
<td>incorrect recording of the advertising expenditure in the years 2000-2001</td>
<td>Ernst &amp; Young</td>
</tr>
<tr>
<td>Bristol Myers Squibb</td>
<td>overstatement of revenues by nearly $ 1 billion</td>
<td>PwC</td>
</tr>
<tr>
<td>Computer Associates</td>
<td>artificially inflated revenue and irregularities in management remuneration</td>
<td>Ernst &amp; Young</td>
</tr>
<tr>
<td>Dynegy</td>
<td>artificially increased liquidity and tax evasion</td>
<td>Andersen</td>
</tr>
<tr>
<td>Elan</td>
<td>creation of 55 companies in order to avoid accounting development expenditure</td>
<td>KPMG</td>
</tr>
<tr>
<td>Enron</td>
<td>artificially increased earnings and hiding debt</td>
<td>Andersen</td>
</tr>
<tr>
<td>Global Crossing</td>
<td>sale of a part of transmission capacity to boost income</td>
<td>Andersen</td>
</tr>
<tr>
<td>Halliburton</td>
<td>incorrect recording of revenues from the implementation of construction contracts</td>
<td>Andersen</td>
</tr>
<tr>
<td>Imclone</td>
<td>Ex-CEO accused of acting to the detriment of the company by using confidential information</td>
<td>KPMG</td>
</tr>
<tr>
<td>Kmart</td>
<td>Accounting irregularities</td>
<td>PwC</td>
</tr>
<tr>
<td>Lucent Technologies</td>
<td>incorrect recording of $ 679 million as revenues</td>
<td>PwC</td>
</tr>
<tr>
<td>Merck</td>
<td>recording of approximately $ 12.4 billion as revenue from</td>
<td>Andersen</td>
</tr>
<tr>
<td>Company</td>
<td>Problem Description</td>
<td>Auditor</td>
</tr>
<tr>
<td>--------------------------</td>
<td>--------------------------------------------------------------------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>Mirant</td>
<td>Insurance, which was never received</td>
<td>KPMG</td>
</tr>
<tr>
<td>Network Associates</td>
<td>Overstatement of assets by nearly $235 million</td>
<td>PwC</td>
</tr>
<tr>
<td>PNC Financial Services</td>
<td>Hiding expenses and overstating income in 1998-2000</td>
<td>PwC</td>
</tr>
<tr>
<td>Qwest</td>
<td>Incorrect entry of $155 million from credit activities</td>
<td>Ernst &amp; Young</td>
</tr>
<tr>
<td>Rite Aid</td>
<td>Artificially driving up revenues in 2000-2001</td>
<td>Andersen</td>
</tr>
<tr>
<td>Tyco International</td>
<td>Using funds allocated to cover the costs of merger to increase profits</td>
<td>PwC</td>
</tr>
<tr>
<td>Vivendi Universal</td>
<td>Hiding of liquidity problems by the executive board</td>
<td>Andersen France</td>
</tr>
<tr>
<td>World.com</td>
<td>Incorrect entry of more than $7 billion of expenditure</td>
<td>Andersen</td>
</tr>
<tr>
<td>Xerox</td>
<td>Punished for overstating revenue and earnings 1997-2000</td>
<td>KPMG</td>
</tr>
</tbody>
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Source: wsj.com

Enron Company with a capitalization of almost U.S. $80 billion fell within a few months after the disclosure of scandals. The company's auditor – Andersen, which confirmed the false information, went bankrupt also. World.com Group in 2002 asked for protection from creditors. The company's debts amounted to about $30 billion.

Financial scandals in U.S. listed companies were not the only irregularities in the capital markets. Also, some "independent" analysts from investment banks (e.g. Merrill Lynch) recommended their clients buying shares of companies that brought the biggest income to their banks. Fraud has been detected also in investment funds. These include late trading and market timing. In the case of late trading the funds, contrary to the law, allowed select customers to buy fund units after their prices were set. By contrast, market timing was based on an aggressive acquisition and redemption of units in the fund and the use of time zone differences between markets. Different closing hours of stock exchanges gave additional opportunities for arbitrage, and therefore such abuse occurred primarily in international funds. This allowed certain investors to make transactions in the fund units at prices fixed in advance, using the latest information. There were, therefore, privileged groups of investors. Such actions increased the operating costs of funds; increased number of transactions makes it necessary to incur higher fees and commissions. It was also necessary in such situations to maintain a higher state of cash. The costs were borne by all investors, not just those who benefited from the scheme.

Negligence in the sphere of corporate governance and lack of proper legal equipment of regulatory institutions are the main reasons of this situation. These scandals have led to increased activity of regulators. The systems of remunerating managers with stock options did not solve the problem of agency, and in some cases exacerbated it. Deteriorating situation of enterprises is often accompanied by increased income of managers.

Regulators of the world's largest public market wanted to show investors that crime would not go unpunished. In 2001, over 50 members of the executive boards of fraudulent companies were
proven guilty and had to reimburse over 10 million dollars\textsuperscript{xi}. Much higher amounts were paid by investment banks, in which various irregularities were discovered\textsuperscript{xii}. As a result of an amicable solution, they agreed to pay about 1.4 billion dollars (Salomon Smith Barney - 400 million, Merrill Lynch and Credit Swiss First Boston - 200 million, Morgan Stanley – 125 million, Goldman Sachs - 110 million, Bear Sterns and Lehman - 80 million each, Deutsche Bank - 80 million) for the construction of a new, independent information system for stock investors\textsuperscript{xiii}. After several years it turned out that these actions have not yielded the desired effect.

At the same time work on a new Act, which was supposed to prevent such practices, began. The “Public Company Accounting Reform and Investor Protection Act” (Sarbanes–Oxley Act of 2002) is aimed at protecting investors by improving the accuracy and reliability of the information disclosed by public issuers in connection with the securities laws. It was also decided to create a board of supervision over accounting in public companies that will supervise the carrying out of audits of public companies subject to securities law. The council was to be a Non-profit company. The Act defines a registered audit firm, which is a firm that is registered by the council and has the authority to audit public companies. In cases of suspected violation of securities law, the Securities and Exchange Commission may carry out investigations, and ask the court for an order restricting or prohibiting the taking of actions that violate or may violate provisions of the Act. The Commission takes no action for infringement of the Law in local self-government organizations, unless the organization has not taken adequate steps to safeguard the public interest and ensure investor protection. According to the Act the Commission prohibits stock exchanges and OTC markets to list securities of issuers who violate any of the requirements of the Act (at the same time the Commission has a duty to take appropriate corrective actions, which would allow the issuer to avoid the prohibition of quotation after adaptation to these requirements.) Disclosure requirements have been also expanded.

It seemed then that the Enron collapse was not in vain. Despite that these are steps in the right direction, they were not sufficient to eliminate further irregularities.

Similar anomalies also exist in other markets, but their scale is much smaller. This is a consequence of the fact that these markets are much smaller. Often, irregularities take another form. Poor supervision by accountants, a large variability of tax regulations, and poorly functioning supervisory boards make detection of various irregularities very difficult. The awareness that such risks exist should contribute to improving the quality of management and supervision (corporate governance). Investors often do not invest in companies that they believe are not managed in a transparent manner. This applies for example, to many Polish companies. These companies could significantly increase their market value if they became more transparent.
Oversight standards used by the state in state controlled companies are very important. Members of supervisory boards and executive boards of state owned companies should be selected basing on experience and qualifications, rather than depending on the results of elections. The basic criterion of selection for these positions must not be party relationships and friendship. Political changes may not lead to loss of independence of supervisory boards. From the standpoint of good governance transparent ownership structure is an important issue.

Investors are willing to pay more for shares of the company, when they know that it is adequately supervised. Proper supervision of the company is often more important to them than the financial performance of those companies.

The size of the declared bonus provides an evaluation of the supervision and quality of the information disclosed in each country. This table shows that in all countries there are doubts about proper supervision. Poland is in the middle of this ranking. This shows how much we still have to do on this issue. At the same time it is information on how to increase - independently of other activities - the prices of the shares. Data from Securities and Exchange Commission (the current name is Financial Supervision Commission) indicates that 357 notices of crime were sent by the SEC to public prosecutor’s offices, only 59 led to the drafting of the indictment, of which only four resulted in convictions. Judgments are usually mild; the courts refer to the "low social harmfulness of an act." These divergent approaches indicate that there is a malfunction of either the Commission or justice. This means that we will not be able to improve the Polish position in this ranking soon.
Analysis of the penalties imposed by the Financial Supervision Commission shows that we are dealing with situations of frequent use of confidential information, delays in disclosure of information, and manipulating information in order to achieve benefits. Two questions arise: first, how many irregularities are detected in comparison with the actual magnitude of these phenomena; second, what is their effectiveness. It is difficult to give unambiguous answers.

**Dissemination of international accounting standards**

Reflections in the previous point were focused on various irregularities, or even ordinary fraud. The problem is much broader, however, and concerns the possibility of setting rules and properly interpreting various accounting issues at the international level. There are many misunderstandings as to the role of accounting. J. Stiglitz argues that contemporary accounting is very complicated, and thus not transparent and makes manipulation easy\textsuperscript{\textit{xiv}}. From such a known economist one would expect more careful statements. It is true that few managers, investors, or bankers are familiar with accounting and are able to correctly read and interpret information contained in the financial statements. Looking at the statements only, even experts in the field of accounting are not able to draw correct conclusions regarding, for example, valuation of financial instruments or other assets, if they are not familiar with the accounting policies used in the company (contained in the notes). It is also important to have the opportunity to ask additional questions, as it is difficult, using existing rules, to define exactly and regulate all situations that may arise in the market. The emergence of new financial instruments does not complicate this situation as much as some might think. It must be remembered that one of the fundamental principles of accounting is disclosure of all relevant events (information) that have a significant impact on the financial situation of companies. Another thing that should be borne in mind by those who speak about accounting or use accounting information to make decisions or assess the situation of a company is a distinction between financial accounting (traditional) and management accounting. Lack of knowledge cannot be explained by excessive complexity of the matter. With regard to different accounting rules, there are many problems, but they are quite well researched. The problem arises only when a choice of a method, such as valuation of individual assets and the various interests connected with it, must be made. It is not as Stiglitz believes that the accountants have, under current regulations, great possibilities of shaping the accounting image of the firm. If they comply with existing regulations and with the accounting policies those opportunities are
very limited”. The problem is, as previously discussed, different types of fraud, manipulation, and frequent changes in accounting rules.

Dissemination of international accounting standards also contributes to improving market efficiency. Different accounting standards used in each country affect the valuation of national companies. This leads to additional transaction costs related to e.g. the costs of adjustment of financial statements to standards of the country of the investor. It may also discourage investors from acquiring certain securities.

The growing pace of foreign investment has increased the importance of international standards for financial reports. Building liquid and efficient capital markets requires reliable and comparable information for investors. The harmonization of accounting systems creates, for many companies, opportunities of offering securities in other countries. Access to these markets becomes easier; commissions and foreign exchange risk are reduced. Credible information makes comparing companies easier. The absence of such international standards often caused the need for preparation of additional reports - in accordance with defined standards. Different capital markets participants may benefit from the dissemination of accounting standards. Easier access of companies to capital markets improves the position of investors, offering them greater choice.

The introduction of international standards must be supported by adequate infrastructure to ensure their proper interpretation and application. The elements of this infrastructure are:

- standards of high quality audit,
- effective and independent introduction (shaping) of accounting standards and high quality audits,
- audit firms with high international reputation,
- systems to ensure professional competence,
- active supervision of compliance with regulations.

The variety of standards in individual countries was caused by different aims that these standards were designed to meet. Lenders or investors, tax authorities, and central planners – all these groups have different expectations. Accounting standards should provide some basic rules to allow comparability of information and their reliability. Clear and reliable information is the basis for allocation decisions.

The quality of information and accuracy of reports is examined by the auditors. Reliable audits are essential for efficient allocation of resources. The importance of auditing has grown following the disclosure of very many cases of so-called creative (aggressive) accounting. Transnational corporations operating in many countries must be subject to special control. This requires that audit firms have very high qualifications. They must have efficient instruments of control.
Building investor confidence requires independent, objective opinion. Once lost confidence is very difficult to rebuild later. It is insufficient that the reports are properly prepared. Investors have also to believe them.

In order to improve the activities of auditors the UK introduced a new code of corporate governance. It will be effective from June 2010. It applies to auditors, and not as it was previously to companies controlled by auditors. It requires major audit firms to appoint independent directors who will not be holding positions of board members. People from outside are expected to provide companies and investors with better assessment of other activities than the auditing of accounts.

The crisis is a period when everyone loses confidence; confidence in auditors was lost too. If a company, which until recently had a high rating and the positive opinion of an international auditor, goes suddenly bankrupt, it seems that something is wrong. The question arises, why companies go bankrupt, and are auditors able to predict it. There are many causes of bankruptcy. It is easier to predict and control what happens in the long run. If the changes are, however, very violent in nature and are often the consequence of external factors, as it happens in a crisis, the situation is more complicated. The auditors usually work within certain frameworks, schemes designated by national or international accounting standards. Crises often surprise them as much as the other market participants. The rapid collapse of the exchange rate, the speculative bubble burst, even if many people point to such a threat, is difficult to predict accurately. Once it happens, determined accounting implications follow. Bursting of a speculative bubble results in a lower valuation of business assets and, depending on accounting standards, fall in profit or increase in loss (IAS\textsuperscript{xvi}) or negative value from the valuation of assets (long-term valuation of assets in accordance with the Polish Accounting Standards). In both cases rapid decline in equity follows. After exceeding a certain minimum level bankruptcy must be declared. Another difficult situation is a sudden cessation of financing by banks. There are only a small number of companies that do not require external financing. The sudden loss of this source of financing, especially when the leverage ratio is high, can lead to immediate loss of liquidity and speedy bankruptcy. The same applies to changes of exchange rates. A sharp weakening of the local currency is also a sharp rise in debt, when part or all of the loans were taken out in foreign currency. What grows, naturally, is the debt denominated in local currency, but this is the currency of financial statements.

The main problem is that accounting and auditing can respond to some negative phenomena with considerable delay. Financial accounting, which dominates the majority of businesses, analyses mainly the past. The capital market is much faster.
References:

i Fragment of the book: “Managers and owners on the capital market, crisis in company management”, edited by M. Bojańczyk, to be published soon)


iv For example, Chilean firms and banks wishing to raise funds in international financial markets, had to obtain ratings as high as the Chilean government bonds from two international rating agencies. Similar requirements exist in relation to many other issuers of securities.

v It is worth to add here that the guarantee of confidentiality makes borrowers more likely to reveal more details to banks than rating agencies.


vii This is usually made by proxy.

viii The pressure to which investors are subject may be seen clearly when shares are quoted in a continuous manner. Even a few seconds delay in the decision is likely to lead to a loss of opportunity of purchasing a security at a specified price.

ix The scale of these developments made people wonder whether we are witnessing the beginning of the collapse of capitalism. However, it seems that it is still a bit too early to say, "[...] it is already the life after the death of liberal liberalism [...] After the collapse of Enron, Tyco and WorldCom, fiasco of World Bank and IMF policies, everyone (except neo-liberal castaways) can see that the emperor is naked. This fall is as exhilarating as once the fall of communism". B. Margueritte, „Tygodnik Solidarność”, November 8, 2002.


xi This is not much, especially compared to losses suffered by owners of these companies.

xii One such irregularity was selling securities that according to the bank's internal evaluations were worthless.

xiii J. J. Wajszczuk, op. cit., p. 41.


xv Accounting regulations often give ample possibilities of, i.e., different valuation of business assets, but introducing a company's accounting policy's one must choose the valuation method and apply it consistently.

xvi From the standpoint of corporate accounting, loss of asset value takes place when the asset value shown in the balance sheet is incompatible with the actual value or recoverable amount (fair value or value in use). Fair value is market value and use value is the net value of the planned cash flows, discounted at a defined discount rate and taking into account the residual value (IAS 36).