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3. Has Smith Report produced recommendations that will improve the objectivity and independence of external auditors?- Katarzyna Gierusz

Articles are connected with the issue of corporate governance. Author discusses the factors such as corporate disclosure, internal control, risk management and independence of external auditors which might help to increase the effectiveness of corporate governance.

1. The role played by corporate disclosure and financial accounting information in corporate governance and the ways in which these forms of information can help to solve the agency problems.

According to the Organization's for Economic Cooperation and Development (OECD) Principles of Corporate Governance (April 2004) the corporate governance framework should ensure that timely and accurate disclosure is made on all matters regarding the company, including the financial situation, performance, ownership and governance of company. However, the corporate disclosure does not have to be limited to those issues. In reply to market's and stakeholders' requests many firms go beyond the minimal requirements. Making all those information publicly known improves corporate governance and solves agency problem.

Nowadays, the governance transparency is the most important feature of company. It is desired by both present and potential shareholders, especially now after Enron's failure. However, the full transparency can be reached only by mandatory and voluntary corporate disclosure. But it can not be limited to non-financial information. As long as balance sheet, profit and loss account and cash flow statement must be made public, the financial accounting information should not be ignored. Moreover, financial information '*has always been demanded by investors for decision- making purposes*' (J. Solomon, 2007). McKinsey emphasizes another role played by corporate disclosure. According to his survey '*investors are willing to pay more for a company that is well- governed*' (C. Roberts, P. Weetman, P. Gordon, 2005) and exposes all information connected with its corporate governance. '*This lowers the cost of capital for the company and so it is in the interest of the company to show good practice*' (C. Roberts, P. Weetman, P. Gordon, 2005). It is also worth mentioning that publishing information might increase the trust to the company. Suppliers will more often give companies a trade credit if they can estimate the contractors' credibility. However, in light of

continual conflicts between managers and shareholders, the corporate disclosure's ability to solve agency problems seems to be the most important.

'*Agency is a general problem inherent in modern complex business and organizational relationships, which arises whenever there is a division of labour or function between people that makes them dependent on others*' (J. Child, 2005). To be more precise, three main problems connected with this issue can be distinguished: agency costs, information asymmetry and objectives' discrepancy. According to M. Jerzemowska (2002) agency costs appear in all kind of companies and on all levels of management. However, '*increased and improved disclosure is likely to reduce agency costs as better information flows from company to the shareholder, which in turn reduces information asymmetry*' (J. Solomon, 2007). Thanks to financial reporting stakeholders, including shareholders, can easier, quicker and cheaper obtain appropriate and reliable information on each company. Accounting information has also a contribution to solving agency problems. '*Information provided by financial accounting systems mitigate agency problems due to the separation of managers and outside investors, facilitating the efficient flow of scarce human and financial capital to promising investment opportunities*' (Bushman and Smith, 2001). Moreover, it has been used to determine management salaries since the company performance and managerial remuneration were linked. This means that financial accounting information aligns managements' and shareholders'.

Is corporate and financial accounting information disclosure really necessary? No, as long as the company owner is the only shareholder and manager (at the same time), is monopolist and use only own recourses. In this theoretical situation the information disclosure would be related only to costs. In others, more real situations the benefits follow from corporate disclosure exceed time, power and money spend on this purpose.

2. Internal control, risk and risk management and their role in effective corporate governance.

Internal control, risk and risk management have recently become a central point of UK corporate governance reform. Those issues are strongly related to each other and to corporate transparency and because of this relationship can favourably influence on corporate governance. Moreover, they are significant to the fulfilment of companies' objectives. However, defining those words seems to be crucial to reach all those benefits.

Internal control can be defined as a process designed in order to provide reasonable assurance of many objectives such as effectiveness and efficiency of operations, reliability of financial reporting and compliance with laws and regulations. '*This definition implies that it is impossible to have complete insurance against risks*' (J. Solomon, 2007). Indeed, all company's activities are connected with risk. This means that there is always more that one possible result of each action. However, there is a way to deal with this issue. Risk, in contrast to uncertainty, is countable. This means that the probability of each result can be estimated. The nature of risk gives an opportunity to manage and control it. As we can see from above definitions internal control and risk management complement each other. They can not be treated separately because only together they can improve effectiveness of corporate governance.

The kind of risk faced by company depends on business activity. That is why each firm has to develop its own approach to internal control and risk management. Regardless of differences each approach, according to Turnbull Report (1999), should include the main stages such as identification, prioritization, estimation, development, implementation, evaluation, disclosure and interpretation. However, the main emphasis and attention should be paid to the internal and external feedback, because this stage can reduce information asymmetry, strengthen the

trust to company and improve relationship with shareholders. According to the survey researching institutional investors' attitudes toward corporate risk disclosure (J. Solomon, 2007), shareholders find such information useful and believe that increased risk disclosure can improve the corporate governance. Moreover, internal control can be treated as a mechanism which can align the interests of managers and shareholders.

The effective corporate governance would not exist without internal control and risk management. Not only do those tools help to detect the company's weaknesses but they also facilitate running business. However, there is one condition to maintain the corporate governance on the high level. The system of internal control and risk management need to be reviewed and updated constantly. As long as those instruments reply on environment changes, market expectations and company needs they can play a role in effective corporate governance.

3. Has Smith Report produced recommendations that will improve the objectivity and independence of external auditors?

The Smith Report was published in January 2003 as an answer to Enron's failure. The case of Enron highlighted the importance of effective external audit. Therefore, the Smith Report concentrated on the relationships between the companies and external auditors and role of audit committees. It was also expected that this document will complement the Cadbury Report's recommendations. However, in my opinion it did no rise to the task.

The establishment of audit committees was a suggestion of the Cadbury Report. However, this recommendation did not create the desired effect, because the corporate failures have still occurred. To improve this

mechanism the Smith Report provided the list of roles that audit committee should play, emphasized its active nature and stressed the importance of independence of all its members. This part of the Smith Report does not arouse my reservation however, time will verify it.

The second group of recommendations is more controversial. I could not help a feeling that the Smith Report relaxes the regulations instead of tighten them. Despite of the Arthur Andersen case, the document did not forbid to perform the audit and non-audit services one client. Moreover, the report suggests that '*there may be genuine benefits to efficiency and effectiveness from auditors going non-audit work*' (Smith Report, 2003). I am not claiming that there are not any benefits, however, in my opinion they do not outweigh the potential problems and consequences as the Enron case has already shown. The Smith's committee did not want to take a responsibility for such unpopular decision and displease audit companies. '*Rather than making specific recommendation on auditing practise the Smith Report seems to pass the buck on to the audit committee*' (J. Solomon, 2007).

To be effective, the external auditor must maintain their independence. However, the recommendation of the Smith Report do not even protect them in theory from undue management influence. Therefore, the external auditors in practice often experience such pressure. They are persuaded to cooperation but the conditions are dictated by managers. The provision of audit and non-audit services brings closer auditors and managers. Because of this close relationship auditors sometimes forget about their objectivity and accept solutions which are in managers' favour. In these circumstances, when auditors' independence and objectivity can be doubt so easily, shareholders can not trust their opinions completely.

The assessment of the Smith Report depends on expectations placed in this document. Those who were waiting for unhesitating moves became disappointed. As a matter of fact, companies have independent audit

committee, but the objectivity and independence of auditors were not ensured. This means that connections between auditors and mangers, corruption and creative accounting are still likely to occur. Therefore, the vision of another big failure is still in the air.

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