Corporate Governance Lesson Taught by the Financial Crisis: A Research Note

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Abstract—Corporate governance represents a highly debated topic, taking significant part of the ink during the last decade. Furthermore, it was the financial crisis of 2007-2009 that brought the subject even more into the spotlight. In the context of a worldwide recession caused by excessive credit expansion [21] central elements of corporate governance, such as executive remuneration; internal control; risk management; the board of directors; independent non-executive directors; and shareholders’ role are nowadays being reconsidered and closely analyzed. Our paper focuses on accounting, traders and remuneration issues. Regardless of the roots we nowadays find at the bottom of recent turbulent times, be them caused by greed, naivety and/or incorrect assessment of risk exposures, highly fragile global governance structures have been uncovered. Analyzing recent events makes us conclude upon the necessity of learning from the lessons being offered through recent turbulent times.

Keywords—Corporate governance, executive remuneration, risk taking, risk management accounting principles, disclosure, moral hazard.

I. INTRODUCTORY THOUGHTS IN THE AFTERMATH OF THE CRISIS

Many things have been said in the aftermath of the 2007-2009 financial crisis, some even considering that acknowledging the importance of corporate governance represents a generally accepted consequence of the crisis. The OECD Steering Group has also issued a report upon the crisis concluding that among its major contributors we find corporate governance failures and weaknesses which that allowed excessive risk taking. The report, suggestively entitled The Corporate Governance Lessons from the Financial Crisis, also mentions a series of other significant contributors such as limited transparency and even lack thereof, prudential standards, risk management, accounting standards and lending activities.

This report analyses the impact of failures and weaknesses in corporate governance on the financial crisis, including risk management systems and executive salaries. It concludes that the financial crisis can be to an important extent attributed to failures and weaknesses in corporate governance arrangements which did not serve their purpose to safeguard against excessive risk taking in a number of financial services companies. Accounting standards and regulatory requirements have also proved insufficient in some areas. Last but not least, remuneration systems have in a number of cases not been closely related to the strategy and risk appetite of the company and its longer term interests. The article also suggests that the importance of qualified board oversight and robust risk management is not limited to financial institutions. The remuneration of boards and senior management also remains a highly controversial issue in many OECD countries. The current turmoil suggests a need for the OECD to re-examine the adequacy of its corporate governance principles in these key areas [14].

[7] investigate the role of corporate governance in the credit crisis documenting that while governance is positively associated with the disciplining of executives for losses incurred during the crisis period, it did not prevent these losses, but instead exacerbated them by encouraging executives to focus on short-term performance. Their analysis is developed on a sample of 306 financial companies from 31 countries. Their results also show that CEOs were more likely to be replaced following large losses if their companies had more independent boards, higher institutional ownership, and lower insider ownership. Moreover they document that companies with more independent boards and institutional ownership experienced larger losses during the crisis, while companies firms with more institutional ownership took more risk before the crisis. In terms of remuneration [7] find that companies which used CEO compensation contracts with a heavier emphasis on annual bonuses (as opposed to equity-based compensation) experienced larger losses during the crisis and took more risk before the crisis.

We therefore remember how the financial press commented a lot based on the words of Chuck Prince, former Chairman and Chief Executive of Citigroup, who was forced to retire when Citigroup had to recognize huge losses due its trading of...
structured financial instruments in the context of the financial crisis:

When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you’ve got to get up and dance. We’re still dancing

(Chuck Prince, former Chairman and Chief Executive of Citigroup).

Citibank is one of the cases illustrating the willingly undertaking of huge risks, risks that act upon shareholders’ capital while the purpose is maximizing directors’ bonuses. What is wrong in this picture is that while bonuses rewarded directors’ activity and risk taking when the crisis revealed the reality of the risks that were undertaken, it was the shareholders who had no option but suffer the consequences.

Under the above presented setting it becomes obvious that directors will also be tempted to hide the risks they have brought upon the entity through their decisions and mislead shareholders. This is where we also need to consider the accountants’ role of reflecting the reality of the transactions taking place, accounting regulations in the field of financial instruments requiring special disclosure meant to help users see beyond numbers (see for example IFRS 7 Financial Instruments: Disclosures). Obviously, the above presented circumstances might lead to a series of pressures being put on accountants’ shoulders once directors have in mind the goal of making all the necessary efforts in order to prevent shareholders from getting in touch with the reality of their trading activity and undertaken risks. The question that naturally goes through our mind when discussing the above presented case is whether Chuck Prince would have had the same attitude in case he was risking his own money instead of those belonging to the shareholders. We somehow have a feeling he would have been more interested in a more appropriate risk assessing procedure and try to anticipate also negative scenarios instead of just looking for the one that maximized his bonuses. Maybe sometimes it is more appropriate to stop dancing even while the music is still singing instead of waiting for the inevitable to happen.

Financial institutions using structured financial instruments assumes their buying and reconstruction within an even more complicated structure if possible and afterwards their selling at a higher price towards other financial institutions. The new buyers will and did of course follow the same recipe. It seems that this category of derivative financial instruments enjoyed the appreciation of nowadays sophisticated bank which seemed to be anxious in actually risking their shareholders money in order to invest in complex structured instruments some knew only little about [5]. That is why investigations searching to find exactly how things got the way they did and turned into such a serious financial crisis that will for sure make history are now focusing their attention on those being responsible with trading these instruments. More precisely, what needs to be clarified is how come corporate governance structures within such entities like Citigroup allowed for these circumstances to develop without risks being signaled. Under poor corporate governance settings one of the risks that became obvious from the above presented discussion is that accountants might be pressured by directors in order to present a reflection that is likeable for the shareholders, but sometimes miles away from the economic truth. Using structured financial instruments creates a series of difficulties from the financial reporting point of view, such as fair value measurements through the use of mark to model valuation.

II. CAPITAL MARKETS BASED RESEARCH WITHIN A TRADE LITERATURE

A series of experts in the field of finance nowadays say that the days for financial engineering developed through off shores are long gone and this is not because of some imposed governmental restrictions, but mostly because financial institutions have understood that using derivatives can even be more efficient [6]. Who would have said twenty years ago that derivatives could be designed so that they allow us to buy and sell credit risk? Still, nowadays derivatives are being traded so that they facilitate banks to sell credit risk associated with their loans portfolio and giving buyers the possibility to diversify their exposure associated to the owned securities by combining credit risk and price risk. Some of these transactions are being done secretly, so that only a few persons within the financial institutions know everything about the purpose of those transactions [6], discretion being a must in the field of creative accounting concerning financial debts, an area we should not forget that is extremely profitable.

This would be the context in which we need to place accounting principles capable of generating informational transparency that is necessary to creating capital markets with as high efficiencies as possible. And if all these realities concerning the opportunities in manipulating accounting information through the use of derivatives, of which we are all aware of, does not represent enough “negative publicity”, the current financial crisis brought derivatives even more in the spotlight, the most common appellative currently used being the one of “toxic assets”.

We are therefore faced with a difficult task, but we will make everything in our power in order to reveal as much aspects in the field of accounting for financial instruments, especially derivatives, with the main purpose of ensuring them a fair trial. As for the current financial crisis, it will for sure say its word through the developed research, being carefully analyzed in order for us to come up with pertinent, rather than impulsive conclusions. When we say impulsive reactions we refer to some tendencies of blaming the international referential, the concept of fair value and also reaching out in order to forbid derivatives’ trading, all these in the context of the circumstances associated with the last years’ financial crisis.

Despite the risks associated with derivatives’ trading, we must not forget the fact that their appearance is the result of a demand manifested within the market. The development of new products, more and more complex, during the last three decades, actually represents the result of answering to the needs of market participants – the result of an unsatisfied demand referring to structuring instruments in relation to the
ratio between risk and expected earnings. Any player on the market knows that this environment is meant to award risk taking, the relationship between the undertaken risk and potential earnings/losses being a direct, well known one [12]. Still, considering our accounting professional path, we have the duty to search for those possibilities that make accounting information as useful as it can be for all market participants, and especially investors, offering them the chance to be as informed as they can be from this perspective, while capital markets obviously impose the use of alternative sources of information. We are meanwhile aware of the fact that, considering any project, limits cannot be avoided. Therefore we consider it would be an absurdity for us to claim that fair accounting reflection of all realities related to derivatives can be absolute, while the true and fair view itself still represents a kind of accounting ‘fata morgana’. Maybe we should understand such circumstances remember what great philosophers used to say some centuries ago, Voltaire concluding that “doubt is not a pleasant condition, but certainty is absurd”.

While the concept of fair value is highly disputed through critics mainly coming from practitioners referring to its applicability, especially during such difficult times within capital markets as the current ones, historical cost still has its supporters based on its advantages offered through the simplicity of application and involved rules [5]. Despite the apparent simplicity, even auditors having it easy only to verify the invoice or receipt in order to certify a value, we must not forget there are always also shortcomings. Where assets are not presented at their correct value, the possibility of hiding losses and manipulation appears within the entity.

Besides these pressures that are being generated through the mechanism belonging to the activities developed by entities their self, we shouldn’t neglect the influence of those factors that operate in the field of accounting with the purpose of developing accounting standards according to different interests, starting with political factors at regional level and even little self interests of greed, which are dangerous to ignore, as seen in history.

All these aspects have helped us in structuring the remaining space for our research in order to finalize the proposed paper. Therefore, we have considered it would be opportune to achieve, as a starting point, an analysis of the accounting regulation process, with emphasis on the field of financial instruments. Once identified the manifestation tendencies within the accounting regulation process during history, we have delimited the proven preoccupation of international accounting referential in this context, therefore underlining the source of the first initiatives in the researched field, as well as their later developments. A case study is also performed within this chapter, being integrated within the same tendencies that we found to characterize the accounting regulation process in the field of financial instruments, a recent amendment on the international accounting referential being analyzed and also trying a quantification of its impact on European level.

The numerous critics found within trade literature when dealing with the mixed attribute have motivated us in dedicating a significant part of our paper to a detailed analysis on what seems to be considered as a shift in accounting paradigms towards the principle of fair value, whose development is closely connected to the field of financial instruments. As a consequence, we have structured that part in such a manner that allows us to closely analyze the development of accounting standards in this area, while also clarifying some concepts. The foresights of the analyzed accounting referential is presented so that found differences and their implications on accounting practices are being underlined, considering the context of a global capital market.

Similar to taking a trip in time, the concept of fair value seems to point us that only the future will bring some clarifications on market based accounting, while continuing to place the concept between two extremes, fair value being considered panacea by its supporters, but also placebo by the opponents of such an accounting based system.

Results within trade literature concerning reactions coming from practitioners indicate the existence of an extremely confuse environment where most “at home” seem to be financial institutions and corporations that are able to exploit the system through choosing those accounting practices that favor them in offering the lowest level of accounting informational transparency, but also in making significant pressures on regulatory bodies when they tend to issue uncomfortable regulations. A series of facts seem to be indicating the need for structural changes within accounting standards, but the possibility of guiding these changes towards the right direction is significantly being diminished through the mechanisms of political and corporate lobby.

A full understanding of how the research on capital markets has developed in time requires a temporal contextualization of the various theories of accounting. Thus, early studies on the accounting of capital markets can be traced back to the end of the ‘60s, immediately after the development of the efficient markets hypothesis and event study methodology. Developments that took place simultaneously in the field of economy and finances have been a theoretical and methodological stimulus for the first manifestations of research that focused on capital markets.

While the efficient markets hypothesis and the current accounting positivism facilitated the emergence of research on capital markets at the end of ‘60, theoretical models analyzing the inefficiency of markets, the development of research methodology and evidence of apparent market inefficiency, can be considered responsible for their catalytic action on a good part of the studies developed at present time.

A clear effect the financial crisis has is the rethinking and reforming of the financial systems through the introduction of new measurement systems and valuation of financial risks but also through higher control on behalf of regulatory institutions, where investment funds, pension funds, life insurance funds and mortgage credits are concerned [10]. We therefore find it appropriate that, under normal circumstances, assets should be measured at what they are worth from the market’s point of view, the market being the only valid standard of value. On the other hand, we do not know exactly...
what to do when the market does not function normally … what standard do we apply then?

Our pleading in favor of the concept of fair value is not meant to argue that this concept is flawless, in the same time being aware that current standards will for sure be further amended to better suit the accounting information market’s needs, as even IASB’s president suggested not long ago. The goal given to fair value accounting and market based valuation, does not seem so exaggerated if we integrate it in the whole picture that presents financial markets’ characteristics in a constantly developing environment that keeps facing us with lessons learned from past crisis. Restricting the use of fair value accounting not only that it would not heal the wounds of the actual financial crisis, but on the contrary it would risk to make them worse, diminishing the trust level that investors have in financial statements of financial institutions [20]. Other changes are necessary for facing the crisis’ challenges, changes that should solution the deficiencies revealed at different levels.

However, beyond the fair value concept itself, it would be advisable to approach the implementation aspect, often underestimated, especially at European Level [20]. The quality and consistency at an international level, regarding the implementation of an accounting referential are vital to assuring a financial stability, as the Banking Supervision Committee shows within Euro system, still before the first signs of the crisis.

It is our belief that the current orientation towards market-based valuations, in risk management as well as in accounting purposes, which we consider will persist at international level, also solicits certain abilities of the valuator, abilities that should be proven. The institutions would have to prove the capacity of performing intelligent and justified valuations of assets and liabilities within the balance sheet, these including complex derivatives as the ones found in the centre of the current financial crisis. As in the case of a driver’s license, these proves have the role to offer the entity’s auditors a reasonable assurance that the valuator has sufficient knowledge and abilities in order not to create any damage towards any implied parties. Unfortunately, the current financial crisis brought to surface severe cases, where no valuation at all is done before committing to an investment and where alternatives were not even searched for achieving some kind of estimations upon the market value, when the considered derivatives were less traded. To these we can add those cases in which inadequate valuation models were used, without giving any helpful information in taking a fundamental rational decision.

What the current financial crisis has confirmed regarding fair value, is that the most dangerous situation is created when the entire valuation process is based on the entity that transactions the securities, without existing any independent confirmation of the created values, from an auditor or from an entity responsible for risk management. We refer here to the 3rd level input data that is allowed only as a final alternative, in the impossibility of applying the previous two. In addition, in this case, accounting standards solicit the disclosure of information that would fully permit the investor to give a certain trust degree to the valuation process, taking the best decision in the given circumstances.

As for the banking industry’s argument that fair value would be irrelevant within inactive markets, this would mean that using fair value accounting would not offer any type of useful information to investors, regarding the true economic value of the concerned derivatives. Nevertheless, as it was previously shown, the decrease in fair values of those derivatives issued in the last years is fully correlated with the significance of the default degree in comparison with what was expected at the initial moment of the issuance. Since these fair values have the capacity to estimate the impact of a higher degree of defaults upon the future and present earnings generated by these derivatives, we assume that we cannot consider them lacked of significance. Also based on these assumptions, we consider that a present or future limitation of fair value accounting would just ‘hide’ current realities, only making the mechanism’s effect that has triggered the financial crisis longer.

In a valuator’s opinion, one of the positive effects of the current financial crisis is that of bringing some light upon those debates that concerned the concept of fair value, from two key aspects’ point of view, urging us to give up a certain accounting utopia that kind of took over the current environment, and get back to financial realities [17]. The first aspect refers to the fact that from a conceptual point of view, creating a balance sheet that has the ability or that needs to offer a true and fair view of the market value of the entity is a great idea, while the market is far too complex in order to be captured by an accounting system.

The second aspect is that the valuation process involves a high degree of subjectivity, and framing this process by a series of accounting rules may be dangerous. [17] appreciates that luckily, restrictions imposed to patrician valuator were quite relaxed. Therefore, simply offering larger and more powerful doses of fair value within accounting trade literature did not necessarily generate a more realistic image of the entities. Even more necessary is the acknowledgement of both limits of accounting through its nature, and complexity of economic reality whose reflections needs to be accomplished.

Placing value in the center of accounting standard setting bodies’ reasoning may induce some assumptions regarding to information being efficiently transmitted within the market, generating securities’ prices that represent a true and fair reflection of the entities’ performances. All these are happening while each financial crisis brings significant doubts concerning the above-mentioned association. We therefore can state that we are dealing with a valuation crisis but at the root of this crisis we actually find the growing complexity of the value creating mechanism, the recurrent dynamic between market value and fundamental value, and last, but not least the amplification of the gap between our own intellectual models concerning value and the new paradigm of value. Fundamental value of an entity mainly depends on how its assets are put into good use, but we cannot ignore the opportunities the entity might hope to have in the future based on her position.
or strategy.

We consider that all these issues that are nowadays raised on improving transparency where fair values are concerned will lead towards the origins of the problems, making us acknowledge basic theories of capital markets. Another aspect of the truth we cannot forget is that investors make their own adjustments upon available information while using it for their own needs. This approach would reduce to a certain degree the importance of the information first being processed by entities and trapped within accounting regulations. As [17] quite properly puts it, the market needs transparency to a greater degree than it needs standards.

III. ACCOUNTANTS’ RESPONSIBILITY, TRADERS’ DECISIONS AND REMUNERATION

Among other concluding remarks, OECD [14] mentions research suggesting that the readability of risk disclosures is difficult and that there are no generally accepted risk management accounting principles. Since turbulent times and events having worldwide echo are known to be causing discussions over regulatory issues, the so-called post Enron period [18] is mentioned with reference to the possibility of misusing off-balance sheet entities (Special Purpose Vehicles). This also applies to the recent financial crisis when banks were taking mortgages and other assets off the balance sheet and financing them separately in Qualified Special Purpose Entities [16]. We can say that prudential regulation stimulated these activities which actually allowed banks to save on regulatory capital while they were also booking corresponding transaction fees.

The problem with off-balance sheet derivatives is that the undertaken risk is not being disclosed and therefore is more than probably not managed properly. We were previously discussing the case of Citigroup. It was proven that Citibank had created Collateralized Debt Obligations that carried a liquidity put that allowed any buyer who ran into financing problems to sell them back at original value to Citibank. The impact of their incorporation within the balance sheet in November 2007 was of 25 billion USD [14], actually reflecting a risk that until that moment was unknown to shareholders.

The accountant and the trader represent two extremely important players that must be acknowledged within the above presented setting. On one hand the accountant has the responsibility of assessing the value of financial assets and financial liabilities within the financial statements in a correct manner. This sometimes represents a quite difficult task. On the other hand it is the trader that makes the trading decision sometimes involving derivative financial instruments that might be a difficult task for him to correctly understand while assessing the risks being involved. As previously mentioned, many of the investment banks restructured already structured financial instruments and further sold them at a higher price. Under these circumstances a trader must be extremely careful when buying such structured derivatives and avoid situations where he might just be paying commissions to the bank counting on irresponsible traders to maximize their commissions. Meanwhile, the trader deciding to buy such structured products will become the owner of financial instruments’ whose value is far different from what it was paid for.

In terms of accounting regulation and the manner in which the international financial reporting standards required for these types of instruments to be measured within financial statements, we must mention the fact that these derivatives should have been separated and in some cases even have the components measured at fair value through mark to market valuation [4]. The process we are referring to is called bifurcation in accordance to IAS 39: Financial Instruments: Recognition and Measurement, nowadays being in the process of replacement by IFRS 9 Financial Instruments. In doing so the result would have been that the value of the exaggerated commissions being paid to banks would be reflected as losses within the investors’ balance sheet. The value of these losses should have been calculated by comparing the sum being paid for such a structured instrument and the real value of its components based on measuring each identified component. On the other hand, when considering a trader who is well aware of the opportunities being offered through extremely complex structured products, a stimulus in buying such products can be precisely the intention of hiding certain losses [5]. In other words, he might have accounting purposes based on the complex nature of these products allowing creative accounting practices.

Sophisticated derivatives require adequate risk management strategies that do not only rely on standard quantitative models, but also on qualified persons to correctly assess the systematic nature of risks [19]. Incorrect assessments of rating agencies must also be mentioned as a factor that influenced the decision making process by hindering the understanding of the risk implication.

A central element of corporate governance that generated intense debates refers to remuneration. Investigations in this area started with remuneration systems used by investment banks and the manner in which this contributed to the financial crisis and afterwards quickly extended to a variety of industries. The Corporate Governance Lessons from the Financial Crisis report was followed by another one that developed on its fact finding with the purpose of further advancing the Steering Group’s action plan on corporate governance and the financial crisis. The key findings of this report [15] in terms of remuneration and incentive systems are as follows:

Remuneration and incentive systems need to be considered broadly and not just focused on the chief executive officer and board members

The governance of remuneration/incentive systems have often failed because decisions and negotiations are not carried out at arm’s length. Managers and others have had too much influence over the level and conditions for performance based remuneration with the board unable or incapable of exercising objective, independent judgment.

In many the link between performance and remuneration is very weak or difficult to establish.
Remuneration schemes are often overly complicated or obscure in ways that camouflage the situation.

The goal needs to be remuneration/incentive systems that encourage long term performance and this will require instruments that pay-out after the longer term performance has been realized.

The tax system has an important influence on both the level and structure of compensation but whether the outcomes are desirable for the perspective of corporate governance is often far from clear.

Steps must therefore be taken to ensure that remuneration is established through a sound governance process where the roles and responsibilities of those involved, including consultants and independent directors, are clearly defined and separated.

It should be considered good practice that remuneration policies are submitted to the annual meeting and as appropriate subject to shareholder approval.

Financial institutions are advised to follow the Principles for Sound Compensation Practices issued by the Financial Stability Forum.

We were discussing in Citigroup’s (and a series of other companies) case how executives were rewarded for undertaking risks that would finally affect shareholders. It would therefore be interesting to observe shareholders’ role in establishing remuneration arrangements. The following table offers some regulatory insights in this regard:

<table>
<thead>
<tr>
<th>Non binding vote on executive pay policy</th>
<th>Binding vote on total remuneration of the board</th>
<th>Vote on total remuneration of management</th>
<th>Vote on stock and option plans</th>
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<tbody>
<tr>
<td>Australia</td>
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Table 1. Shareholders’ role in establishing remuneration arrangements

Source: [15]

*In the Netherlands, the binding vote concerns changes to remuneration policy and in Denmark it is confined to the variable component of executive remuneration.

It now seems obvious and pretty simple to understand why some remuneration systems, such as linking compensation to quarterly performance was equivalent to encouraging short-term gambling. Furthermore these practices and the pay they generated were supposed to be supervised by the boards of directors. In such cases it seems more like corporate governance represented a tool that helped gain stakeholders’ trust while covering the ugly truth. Trade literature considers that the way remuneration schemes are designed and supervised can have systemic impact on the financial system.

As we previously mentioned, the issue of remuneration is mostly debated within the context of financial institutions and we believe this continues to be true even in the aftermath of the crisis especially if we consider those banks that benefited from government bailouts [10]. As [9] underlines, the impact of public sector balance sheets absorbing losses of the banking sector has had the after-effect of contributing to sovereign debt crises in several smaller European jurisdictions — which continue to plague investors, taxpayers and the wider economy. This is more reason why we also consider that remuneration continues to represent a fundamental issue that must be accordingly approached. Meanwhile the position of systemically important banks [9], particularly those benefiting of state provided financial support, will be further drawing attention on issues related to executives remuneration.

IV. Morality Issues

A broader approach of the setting makes us first think about corporate governance and how it should have stopped extremely risky transaction from taking place within an entity. An important aspect that must be considered is avoiding the development of reward systems for directors and other employees that act as traders that allow the hiding of mistakes being made within their activity. When such systems exist there is also the possibility of consequences reaching up to the level of accounting practices and putting pressures on accountants as well. This practice actually represents a reality that comes up in history starting with the first financial scandals that shook the accounting environment at the beginning of the 21st century.

Directors being able to obtain huge rewards even when considering cases that ended up with monumental bankruptcies and failures makes for them to be tempted in undertaking exaggerated risks. The natural consequence will afterwards be for them to try and hide these risks and the potential losses therefore being generated for as long as possible. We are dealing here with moral hazard issues, an inappropriate rewarding system enhancing directors’ behavior in maximizing their own bonuses while sometimes even destroying value from shareholders’ point of view [1].

We therefore must in some cases acknowledge the intention of hiding risks and losses that should affect financial statements, derivative financial instruments particularly creating the opportunity for such manipulations. Such a case often affecting financial reporting is that referring to extremely complex structured products that are also extremely difficult to measure and were therefore kept outside the balance sheet, once again helping the hiding of potential losses, as previously discussed.

Still, corporate governance specialists state that they were not surprised by the situation being created right before the financial crisis and by the record level of bonuses being offered to directors such as the one mentioned in our above presented analysis. Directors’ being able to obtain such benefits and then just leave the entity creates a situation that
seems to be too simple not to have been considered. Still, as simple it is as dangerous situations it created, stimulating directors in generating losses that afterwards affected the shareholders.

These issues are nowadays debated and analyzed in what aims to be our attempt to learn from the crisis. As Rasheed Mohammed Al-Maraj, governor of the Central Bank of Bahrain was also emphasizing in his keynote speech at the Gulf Cooperation Countries Board of Directors Institute in November 2010, unfortunately, the financial crisis has provided many illustrations of failures of corporate governance, a common pattern being established in the financial institutions that have failed since the summer of 2007. He also opened the discussion upon the reward systems being used by financial institutions: a major contributory factor to the financial crisis was that the staff of financial institutions was rewarded for short-term risk-taking. The incentive structures created by bonuses paid over a limited time horizon encouraged traders to focus on short-term profitability and financial engineers to design new financial instruments that could generate immediate profits, while the risks were pushed off to some indefinite future date. As a consequence of these situations taking place, banks have afterwards tried to restructure the bonuses they offered based on a long term performance of shares’ prices rather than their short term performance [11]. A temporal correlation of directors’ and shareholders’ interest is therefore to be considered.

[9] signals a moral hazard issue that represents a particular feature of the financial sector. That is how in good times bankers are set to make fortunes both at executive and below board levels of the organization while in severely bad times the state, and ultimately the tax payer, pays the bill because of their systemic importance to the economy. It is these particularities that also require specific approaches in terms of financial institutions’ corporate governance. In this regard we must mention the European Commission’s Green Paper [8].

An interesting study analyzing the connection between risk taking and executive compensation in financial institutions is that of [3]. By using a theoretical model of shareholders, debt holders, depositors, and an executive their study suggests that the principle, excessive risk taking may be addressed by basing compensation on both stock price and the price of debt, but shareholders may be unable to commit to designing compensation contracts in this way and indeed may not want to because of distortions introduced by either deposit insurance or naive debt holders. Exemplifying a part of their framework, [3] suppose the manager decides on the level of risk and the manager’s contract is composed of three components: a fixed wage, a loading on equity as well as a loading on the Collateralized Debt Obligation’s spread.

\[
compensation = \bar{w} + s_E P_E + s_D (\bar{P} - P_{CDS})
\]

(1)

The price of debt is considered to be a credit default swap (CDS) spread, which is liquid and should react fundamental risk. Since the CDS spread is increasing in the probability of default, it is judged relative to a high benchmark \(\bar{P}\) in order to align the manager’s incentives. This benchmark may come from a weighted industry CDS spread or from a reference spread under a given risk exposure \(q\). The price of equity is given by the present discounted value of equity cash flows net of origination costs \(c(q)\) and expected debt repayments \((1 - q)(1 + R(q))\). [3] note that in the low return state the bank defaults and shareholders get nothing, so that the price of equity is given by:

\[
P_E = q(x + \Delta) + (1 - 2q)x - (1 - q)(1 + R(q)) - \frac{1}{2} \sigma q^2
\]

(2)

Where \(q\) represents the risk that bondholders believe the bank will implement through the compensation contract;

This only represents a brief exemplification of their theoretical framework. The obtained results of the implemented testing are also noteworthy. The developed empirical analysis meanwhile documents that debt-like compensation for executives is believed by the market to reduce risk for financial institutions.

V. FINAL REMARKS AND FURTHER DEVELOPMENTS

As we are all currently witnessing, derivatives can easily have negative effects. That does not mean that we should forget their ingenuousness in offering the opportunity to separate risks from their source and lead them to parties that are willing to bear them while getting a chance to a matching reward. The simpler a derivative is, the fewer places for manipulation it leaves, but this does not mean that derivatives should be completely eliminated. Where do these instruments become toxic? Exactly where they lack transparency and therefore information. Once again, we will all have to learn from the crisis, while each chain of the financial system must review its role, attributions and responsibilities, permanently encouraging informational transparency. Corporate governance therefore represents a key player for any entity.

As long as markets continue to give such great importance to numbers being recorded within financial statements while also making it possible for management to reflect its own beliefs concerning these figures and also put pressures on accountants and their activity, we conclude that there is more work to do in the field of financial reporting, and especially in the case of financial instruments, until the use of fair value, that should be the one reflecting the markets’ perception upon the element being valued, to be done in an appropriate manner. Using mark to model in determining structured financial instruments’ value may in this case only help dress-up financial statement [2].

We are nowadays finding ourselves again trapped when searching for a compromise between unrealistic expectations for financial reporting transparency, how it can help us and how we can reach it, and the real world which is based on human actions that we cannot control for. Despite all these aspects we are still intrigued by capital markets’ tendency to learn all over again from the same lessons each decade or decade and so, this deja-vu feeling constantly being with us, but never completely acknowledged.
As our analysis used OECD’s reports we must also conclude by making reference to OECD’s Conclusions [13] and emerging good practices to enhance implementation of the Principles building on the previous two [14, 15] which also represented phases of the OECD Steering Group on Corporate Governance action plan on corporate governance and the financial crisis.

In terms of our final remarks we wish to go back to the title of the first report [14], namely The Corporate Governance Lessons from the Financial Crisis. The title of our paper is also inspired by it but emphasizes one important thing through the use of the verb taught. We consider that the recent financial crisis, as many other turbulent times in history, has tried to teach us some important issues, many of them related to corporate governance and risk management. Furthermore it is our opinion that it also depends on us to make sure that we learn from these lessons and correctly assess their insights.

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