Considerations on the Financial Crisis, Management and External Disclosure

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Abstract

The financial crisis erupted in 2008 has lead to a real recession affected by several economic drivers. The global financial crisis, brewing for a while, really started to show its effects in the middle of 2007 and into 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.

On the one hand many people are concerned that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelihoods of almost everyone in an increasingly inter-connected world. The problem could have been avoided, if ideologues supporting the current economics models weren't so vocal, influential and inconsiderate of others' viewpoints and concerns.

This work aims to identify the main economic business forces that have contributed to the bankruptcy of some firms or at least contributed to significant functional difficulties. In this sense, we explore the questionable actions of management as well as the lacking financial disclosure affected by the incomplete harmonization of accounting standards.

Introduction

In recent years the financial markets have experienced a great expansion also because of the inadequate international regulations. These markets have, by nature and definition, among their primary functions, allocation risk; but in recent years there has been an economic failure. It is difficult to identify all the reasons which are the basis of the events that have occurred, but in an attempt at systematization we can identify the following factors:

- underestimation of the risk assumed by many brokers who have not been able to manage and control the risk involved;
-assessment made in relation to the exposures of individual institutions, not taking into account the systemic risk;
- frenetic financial innovation with the creation of financial instruments of any kind, without paying sufficient attention to possible effects in terms of risk;
- insufficient regulations to ensure proper and efficient market development;
-control exercised by the competent authorities in a non-punctual and attentive way, especially in reference to 'overall debt contracted by intermediaries and the risk profiles assumed.

Furthermore we can add other economic reasons in business, including:

- "opportunism" management which aimed at determining behaviors oriented to generate excessive remuneration and which are commensurate with the results in the short term and do not create conditions for the maximization of enterprise value for stakeholders;
- incomplete and superficial external communication and the consequent lack of adequate disclosure;
- accounting harmonization in progress, but still far from reaching satisfactory levels of homogenization.

In the first instance, the great responsibility of management in the explosion of the crisis is evident and the inability to control the unpredictable negative evolution and devastating effects, especially in Anglo-American countries , in which the government enterprise is entirely in their own hands and the methods used subject to the judgment of the market.

This responsibility emerged as particularly significant in the management of financial institutions, despite the existence of authorities and supervisory rules governing operation management by defining the limitation of risk. The latter, in fact, is measured and verified in relation to levels of solvency and liquidity of banks, considered adequate to safeguard the soundness of the financial system as a whole.

The rules of supervision and control activities carried out by the competent authorities, unfortunately, have not been sufficient to prevent the development of operations and financial products not yet carefully regulated and communicated to the market in their risk profiles according to patterns.

The financial crisis among the various critical aspects of the functioning of modern capitalist economy has shown the difficulty of the external communications business to make the stock market management aware, and thus facilitate the rationality of behavior and choices of the various economic agents.

We must also consider the impossibility of international standard setters to achieve the process of global harmonization of accounting in a short time.

Despite the gradual introduction of IAS/IFRS, the final goal is still far away. This paper aims to analyze the connections between the motivations of matrix business management and highlight the development of the financial crisis.

In Section 2 we will highlight the connections of the crisis with the performance of management while in section 3 we will show how external communication and accounting rules have become the instruments of control over management. In section 4 there are the conclusions.

The work of management, the internal control system and market discipline

The desire of large businesses to grow in size in a highly dynamic and competitive environment through the use of external sources of financing from new investors and lenders in many cases has led to the action of the management strategies which are only just balanced and not always consistent with the Company's medium to long term goals. These strategic choices have not been able to reconcile the interests and the distinctive individuals who, for various reasons, exercise their powers or participate in other ways in the company.

It is no coincidence that the recent financial crisis erupted mainly in the Anglo-Saxon world as a natural consequence of the remarkable development of the public company, the evolution of the capital market and, in particular, the significant presence and considerable activism of institutional investors.

In Italy, given the structure of the enterprise system, characterized by family capitalism and a general phenomenon of under-sizing, the crisis was felt with the same great

intensity, but in a completely different way . In our reality, in fact, the discretion of management is greatly attenuated by the presence of the management board that, in most cases, can effectively protect the interests of the property.

For once, then, Italian companies have been affected only indirectly from the frantic evolution of the crisis and have found, in their own structure the strength to control the devastating effects.

The events of recent years show that the management has found increasingly difficult to share their choices with stakeholders (P. L. Cochranr. A. Wood 1984; D. J. Collis-C. A. Montgomery, 1999; E. Freeman-W. M. Evann1990; E. Freeman-G. Rusconi-M. Dorigatti, 2007; A. L. Friedman-S. Miles, 2006; C. W. L. Hill-T. M. Jones, 1992, M. Jensen, 2001; W. R. Mills-B. Weinstein, 2000; A. Rappaport, 1998; G. Slinger-S. Deakin, 1999; J. S. Wallace, 2003) in order to create conditions for cohesion between them that often fuel divergent interests in their visions of short and long term.

This situation, well known and analyzed in the relationships of agency (Hill, C. W. L. and Jones, T. M. 1992) has led management to make the process of achieving the business objectives very obvious and less transparent and the effectiveness with which the strategic and long-term objectives tend to be fulfilled.

The management, in fact, often finds itself in the difficult position of having to communicate to at least one of the stakeholders, results that were not in line with the expected ones from such individuals but consistent with the objectives that they set themself to achieve. This was the case for the "myopic behavior" of some managers who were too intent on guiding and developping their actions in order to increase their own personal benefit. The exceptional proliferation of the stock option plans should be noted, especially in Anglo-American countries. (Defusco, R. A., Johnson, R. R. and Zorn, T. S. 1990, Shane A. Johnsona, Yisong S. Tiana, 2000; Quagli A., Avallone F. and Ramassa P., 2006). Stock option plans aim to capture a large part of the wealth produced by the company and not support the proper functioning and the process of actually creating value.

We must not forget, in this sense, the attention paid by management to generate unjustified increases in stock prices through short-term strategies that gave rise to a performance which was strongly influenced by its risk profile. The latter did not have any real processes of value creation able to increase the firm's market value, but were functional only to increase that of stock options, with speculative effects that were not always controllable.

The problem, in other words, is related to the information asymmetry between those who live within and outside the enterprise and the importance that the information may have to the perception of managerial conduct (Simon, H. A, 1985; Leland H. E. -Pyle D. H., 1995; PM Healy, KG Palepu, 2001; Lev, B., Zarowin, P., 1999; Lin, H., McNichols, M., 1998; Lundholm, R., 1999).It is important to note that, in cases where management has implemented the hazard moral actions, thanks to information hidden from the market and, therefore, removed from the analysis, the system of internal controls has not exercised its function effectively. The internal control system (Comoli M. 2002; Lorange P., 1980; Zanda G, 2002), in practice business management, is identified in the set of activities in the formal and substantive sense allow the creation and control of processes oriented towards the achievement of an effective and efficient business. This system is, in its main features, an integrated process of working relationships between the different business areas, and serves as the necessary conditions for proper evaluation of the effectiveness and efficiency of the organizational structure and operational structure as well as business risks. The system of internal controls, in other words, should enable management to be aware of the key success factors at its disposal as well as the protection of corporate assets and the phenomena of risk present in the operational processes. The control is essentially strategic, managerial and

operative even before enabling business decision makers to manage and monitor the strategic choices made, adapting quickly to:

-the changing conditions of economic and financial development;

- the risks associated with events that may affect and have an impact with different consistency of objectives and results;

- the risk that the processes differ from those indicated in terms of business planning.

The evidence relied upon had a significant effect on the work of management in recent years, creating conditions that led the latter to show a dangerous state of superiority and abuse with respect to the control system, on the knowledge of the risks inherent in the operations and the choice of company products.

This system, in essence, is distinguished for its existence only in a formal sense, with the effect of producing an inappropriate heaviness of the bureaucratic processes of screening and monitoring of business decisions.

It follows that its role in stimulating and motivating everyone involved in these processes in the company to achieve the desired results has failed, thus taking away from the firm a shared culture that is an element of absolute importance to balance the different interests that flow in the company. As a result of the failure of the system of internal controls, the company gives to the market the difficult task of monitoring and controlling actions that give life to the company.

In the so-called managerial capitalism, in fact, the only form of external control of the work management is represented by the rules of the market in its development to safeguard the effective and efficient management of the company.

The inability to self-regulate the business and balance the different interests of stakeholders represents the yield to the market that in its judgments and mechanisms makes the company contestable. The takeover (Fortuna F., 2001) is the main example of discipline that the market exercises in respect to the public company to ensure an effective system of corporate governance, protecting both the corporate and the public interest.

This operation expresses and materializes the contestability of the corporate governance, representing the means by which the so-called “market to control” to shared values manifests itself towards the interests and objectives that converge into the enterprise.

For the market to trigger this articulated instrument of scrutiny of the company and to dispute the ownership, it is necessary that the company:

- projects in its capitalization its "carrier" owner and institutional structure;
- sends information relevant to the determination of its value current and future to the market.

The latter assumption, however, has been strongly rejected, making the action of the management less exposed to mechanisms of "penalty" on its work, even in this case, therefore, we are faced with a failure of the market rules.

External communication and accounting rules as instruments of control

In issues of corporate governance the information and its dissemination-communication outside play a role of absolute centrality.

It is precisely these elements that are essential to balance the different interests of stakeholders and, more generally, for the effective functioning of the whole company and for the achievement of objectives. External communication business (Terzani, S., 2002; Miller, G., Piotroski, J., 2000) has changed over time and has become more relevant to the effect to the growth of firms, of the subsequent evolution of its social role and their need to raise capital in the financial market. This importance has been increasingly established as a result of the wide diffusion of multinational enterprises and greater contestability of corporate

governance. The tendency of large enterprise to grow by diversifying their product lines and the related need to attract new investors and lenders makes it desirable and necessary to supplement the traditional disclosures with new analysis tools that make it possible to evaluate the results achieved in relation to risks in assets.

At the unitary representation of the results of the firm in the budget, therefore, also includes an assessment of the same according to the main risk factors, and this allows more analytical and detailed operating conditions of the business and to verify the existence of the conditions of economic and financial equilibrium, critical to the survival of the company.

The effectiveness of external communication is essential for the achievement of a satisfactory level of information transparency.

The quality of corporate communication has unfortunately been subject to insufficient attention from the management of the companies that have been affected by the current crisis.

Accounting rules and their respect have the effect of producing transparency, understandability and comparability of instruments and form in which the market can effectively control the behavior of management and evaluate the process of the formation of the firm's market value.

Overcoming the accounting traditions to which individual countries were always anchored,
was inspired by knowledge that the current global

knowledgeable, willing, could express in this way market can expresses its full potential for growth only in the presence of homogeneous standards.

The standard setters, as is known, have focused new accounting rules on fair value of the assets, convinced that the free transaction between market participants, could express the real value of corporate assets (Andrei P., 2008, Pizzo M., 2000; Rossi C., 2003, M. E. Barth-W. H. Beaver-W. R. Landsman, 2001; R. Holthausen-R. Watts, 2001; W. Landsman, 2001; C. Laux-C. Leuz, 2009; S. H. Penman, 2007; K. Ramanna-R. L. Watts, 2007; N. Veron 2008; P. J. Wallison, 2008.).

Failure to achieve an adequate level of harmonization and incomplete public disclosure of corporate information have made ineffective mechanism control over management which, unfortunately, only later to the onset of the financial crisis, became influenced by models business management which were not really focused on maximizing value for stakeholders.

In the various roundtables which were developed about the financial crisis, it has become very clear that the domain of the factors that gave rise to the crisis hinge on a better and easier understanding of corporate events that can be guaranteed by a more regular public disclosure of information about how the business goals are pursued while respecting the interests of the economy that gravitate around it.

It is clear that the rules on the external communication must allow to the representation in a clear and transparent "state of health" of the company.

The information, in other words, must support the integrated judgement of evaluation of the value and should help make the knowledge of risk factors possible.

The latter concern, shared by the teaching business management, the main market analysts and verified by empirical studies, is the result of difficulties in incorporating mathematical model elements of an intangible nature, whose quantification can be reasonably estimated in a "range" of probable values .

These methodological difficulties, increasingly research in science, there is added a lack of information on operational strategy on the conditions of the equilibrium of the company.

The above is in fact, highly dependent on information available to feed formulas for evaluation and, if due consideration is given, allows increasingly aware and demonstrable judgments on the business value.

The information inefficiencies found in companies involved in the financial crisis, while they are often motivated by management, have undermined the image and credibility of the same towards the stakeholders and, more generally, the confidence in the functioning of the economic system as a whole.

Conclusion

The events of recent years show that the management has found it increasingly difficult to put strategies in place which are also in line with the needs and expectations of stakeholders. This is the case whereby the nearsighted behavior of some managers who were too intent in directing and developing their actions in the short term so as to increase the personal benefits.

Management has often withheld from disclosing some information about the process of achievement of corporate objectives and the effectiveness with which the strategic long-period tends to materialize.

This aspect is further complicated, because in most cases, the governance structure of the companies most affected by the crisis had the management as the owner and almost exclusively the choices of strategic and systems of internal control have showed very important limits.

Therefore there is in essence, a set of conditions that resulted in a state of superiority and abuse of management with respect to the control system, in the knowledge of the risks inherent in the operations and the choice of company products.

The system of internal controls, in fact, is primarily distinguished only for its existence in a formal sense, with the effect of producing an inappropriate cumbersome bureaucratic process of screening and monitoring of business decisions. The evolution synthetically described was determined also by the difficulty the regulator found in regulating aspects whose evolving amplitude and management complexity are difficult to standardize in well-defined rules, unless following the general guiding principles.

The variable that has characterized all of this is connected to the information asymmetries that exist between those who live inside and outside of the enterprise and the importance that the information may have for the perception of managerial behavior. The recent financial crisis has shown that all the efforts made to have information that can be used profitably for understanding and monitoring the performance of management, fostering contestability of the market and making rational choices by economic operators, must still be calibrated with accuracy if they are not to be in vain.

The effectiveness of the information, moreover, can be evaluated on the basis of their degree of usefulness that presented for verification and control of the business goals. Its disclosure is essential to achieve a satisfactory level of information transparency.

The incomplete public disclosure of corporate information combined with the failure to achieve an appropriate level of accounting harmonization made mechanisms of control over management ineffective, which, unfortunately, only after the onset of the financial crisis, became conditioned by business models which are not really focused on maximizing value for stakeholders.

The information, in other words, has not been able to fully support the judgment integrated assessment of the economic value of the company It would help, to that effect, to understand and investigate the increasingly crucial risk factors in order to express a reliable assessment which is in line with the conditions of the operation of the business. The tangible results to

date have been those to systemically spread managerial behavior and questionable professionalism and poorly understood by values financial performance and short-term, unsustainable relative to its risk profile.

The opportunity for management to share their work with the stakeholders, requires the development of new methods of measuring the economic efficiency of business and the modes of external communication that always stay aligned to the internal systems, in the light of the need to make transparency known to the stakeholders as well as business performance, risks and more generally, the process of value creation.

It is appropriate, in this sense, not just to anchor economic models in corporate rules resulting from accounting and prudential control theorists, but to integrate them with aspects of the study of the behavior of management. Certainly the scenario that has occurred and has been outlined here does not facilitate the maintenance and strengthening of the positions of equilibrium; businesses, therefore, have to appeal to all resources at their disposal to deal with the difficult and impose plans in the medium and long term to enable the recovery of the conditions that existed before the crisis. It is necessary to put an end to the discretion of management by establishing rules of conduct to prevent the prosecution and realization of intent that do not favor and are not even compatible with the general objectives of the company.

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