

©2011

Ronald J. Strauss

ALL RIGHTS RESERVED

Business Ethics and Accounting
Information in Light of the Financial Crisis of 2008

By: Ronald J. Strauss

A dissertation submitted to the Graduate School – Newark

Rutgers, The State University of New Jersey

In partial fulfillment of requirements for the degree of

Doctor of Philosophy

Written under the direction of

Dr. Michael A. Santoro

and approved by:

Newark, New Jersey

May, 2011

UMI Number: 3460712

All rights reserved

INFORMATION TO ALL USERS

The quality of this reproduction is dependent on the quality of the copy submitted.

In the unlikely event that the author did not send a complete manuscript and there are missing pages, these will be noted. Also, if material had to be removed, a note will indicate the deletion.



UMI 3460712

Copyright 2011 by ProQuest LLC.

All rights reserved. This edition of the work is protected against unauthorized copying under Title 17, United States Code.



ProQuest LLC.
789 East Eisenhower Parkway
P.O. Box 1346
Ann Arbor, MI 48106 - 1346

Abstract of the Dissertation

Business Ethics and Accounting Information in Light of the Financial Crisis of 2008

By Ronald J. Strauss

Thesis Director: Professor Michael A. Santoro

This dissertation examines, from an ethical perspective, the vulnerability of the U.S. financial system that was exposed in the financial crisis that began in 2008. Three essays are presented, each of which examines an aspect of the relationship between business ethics and risks to the financial system.

Essay 1 presents an ethical analysis of executive incentive compensation plans that rewarded excessive risk taking by basing cash-based incentive compensation upon accrual-based net earnings. Essay 2 offers a historical account and ethical analysis of how the post-Depression U.S. financial system allowed, or even encouraged, individual financial institutions to become too-big-to-fail and too-interconnected-to-fail. Essay 3 a broader theoretical paper, develops a framework for applying ethical analysis to the accounting measures and disclosures communicated by a firm.

While each essay is a distinct analysis, the dissertation is also an integrated work that illuminates the complex general relationship between business ethics and the capital markets, as well as the specific role of accounting information in ethics and the long-term viability of the financial system.

Acknowledgements

I would like to thank my dissertation chair, Professor Michael A. Santoro, for his invaluable advice and guidance during the conception, design, and completion phases of this dissertation. Professor Santoro has become a valued advisor and mentor who has consistently supported and encouraged my research interest. My work is much stronger, as a consequence of having had the opportunity to work under his supervision.

I am very grateful to my dissertation committee members Professor Wayne Eastman, Professor Miklos A. Vasarhelyi and Professor James Gathii. Each professor has had a vital role in helping me successfully complete this dissertation, and I am very grateful for their ideas and support. The quality of my work has substantially improved as a consequence of the involvement of my committee. I would also like to thank both Professor Eastman and Professor Vasarhelyi, whose courses I took as part of my Ph.D. program, for generously sharing their expertise and knowledge, and being supportive of my research interest throughout my years as a Ph.D. student.

Finally, I would like to thank my wife, Jennifer for her understanding during the countless hours when I was unavailable. In addition, Jennifer's expertise has been particularly helpful during the editing and proofreading phases. Without her support and understanding, as well as our son Ben's, I could not have successfully completed this dissertation.

Dedication

To my parents, Jack and Anny Strauss, my wife Jennifer, and my son Benjamin.

TABLE OF CONTENTS

Chapter 1: Introduction	1
Chapter 2:.....	3
Cash-Based Executive Incentive Compensation and Net Earnings: Ethical Analysis in Light of the Financial Crisis	3
Abstract.....	3
2.1 Introduction.....	4
2.2 Literature Review.....	7
2.2.1 Executive Compensation - Equity-Based Incentive Compensation.....	7
2.2.2 Executive Compensation -Bonuses and Non-Equity Incentive Compensation	8
2.2.3 Performance and Pay	10
2.2.4 Pay for Illusory Performance	13
2.3 Ethical Analysis	18
2.3.1 Paper Profits and Cash-Based Compensation: Misaligned Interests Resulting From Timing and Risk Allocation.....	18
2.3.2 Moral Aspects of Fiduciary Duties	20
2.3.3 Moral Hazard to Moral Failing: The Moral Duties of Fiduciaries Regarding Cash- Based Compensation.....	23
2.3.4 Extending Moral Duties to Self-Limit Cash Compensation Beyond CEOs to Other Corporate Executives.....	26

2.3.5 Moral Theories.....	28
2.4 Social Historical Context	30
2.5 Conclusion	32
References.....	37
Chapter 3:.....	43
Too Big and Too Interconnected to Fail: Historical and Ethical Analysis of the U.S. Financial System.....	43
Abstract.....	43
3.1 Introduction.....	44
3.2 Historical Analysis.....	45
3.2.1 Background: Overview of Financial Oversight and Regulation in the United States..	45
3.2.2 The Financial Crisis of 2008.....	48
3.2.3 Too Big To Fail—Too Interconnected to Fail: The Longstreth Thesis	50
3.2.4 Wall Street Firms Convert from Private Partnerships to Public Corporations	52
3.2.5 Securitization, Credit Default Swaps, and the Relaxation of Capital Requirements	56
3.2.6 Too Big and Too Interconnected to Fail	58
3.3 Ethical Analysis	59
3.3.1 Introduction.....	59
3.3.2 Collective Moral Agency.....	61
3.3.3 Institutional Moral Hazard.....	64
3.4 Crisis Intervention.....	66

3.5 Conclusion	67
References.....	69
Chapter 4: The Ethical Content of Accounting Information.....	73
Abstract.....	73
4.1 Introduction.....	74
4.2 Literature Review.....	76
4.2.1 Financial Statement Fraud	76
4.2.2 Financial Crisis Implications	77
4.2.3 Accounting and Society	78
4.2.4 Accounting Information.....	79
4.2.5 Corporate Moral Agency	81
4.2.6 Ethics and Accounting Information	83
4.2.7 Accounting and the Public Interest	89
4.2.8 Briloff	92
4.3 Ethical Analysis	93
4.3.1 Ethical Content of Accounting Information	93
4.3.2 Discretionary Accruals	94
4.3.3 Measures of Conservatism.....	95
4.3.4 Voluntary Disclosures.....	96
4.3.5 Uses of Accounting Information.....	97

4.3.6 Systemic Implications.....	98
4.4 Conclusion	98
References.....	100
Chapter 5: Conclusion.....	104

LIST OF TABLES

Table 1.1	Total Cash Incentives for the Top Five Senior Executives at Each Firm.....	15
Table 1.2	Cash-Based Compensation as Percentage of Net Income.....	17
Table 1.3	Compensation—Top Five Senior Executives.....	28
Table 4.1	Ethical Content of Accounting Information—Decoder.....	97

Chapter 1: Introduction

This dissertation research, grounded in current business and accounting ethics scholarship, examines the surprising vulnerability of the U. S. financial system, which was exposed as a consequence of the financial crisis that began in 2008. Such vulnerability became apparent in September 2008 when the financial system seized, liquidity dried up, and fear of a catastrophic economic collapse took hold both in the United States and globally.

Three essays are presented, each of which examines an aspect of the relationship between the ethics of business and risks to the financial system. Essay 1, an examination of an established financial industry practice, presents an ethical analysis of executive incentive compensation plans that may have rewarded excessive risk taking by relying on accrual-based net earnings as a basis for cash-based compensation. Such payments of cash-based incentive compensation in the financial industry are examined under several forms of moral theory, and in each case moral justification for these practices cannot be found. Essay 2, an examination of the U.S. financial system, presents a historical account and ethical analysis of how the post-Depression U.S. financial system enabled a number of financial institutions to metamorphose into financial behemoths “too big and too interconnected to fail.” Essay 3, a broader conceptual paper, develops the theory that, in addition to financial information, there is ethical content in the accounting measures and disclosures made by a firm. For an

entire economic or financial system, the argument is developed that such information may prove useful for understanding and moderating systemic risk.

While each essay presented is a distinct analysis, as an integrated work this dissertation contributes to illuminating the complex general relationship between business ethics and the capital markets, as well as the role of accounting information, and the long-term viability of the financial system. The dissertation contributes to deepening the understanding of these complex and interrelated factors, and in doing so provides analysis which may be useful in avoiding similar crises.

Grounded in the work of moral philosophers, including Rawls, Kant, Bentham, and Aristotle, as well as modern-day business ethicists, these essays illuminate the relationship of the ethics of business to the long-term viability of the financial system. Such sustainability and long-term viability of the economic and financial systems of the United States, is one central assumption underlying this dissertation, and provides the framework for the examination of the ethical aspects of the global financial crisis.

The complexity and importance of the modern day financial system demands ongoing analysis that strives to bring clarity of understanding and transparency to the system's ethical architecture. In this sense, the work here is a beginning.

Chapter 2:

Cash-Based Executive Incentive Compensation and Net Earnings: Ethical Analysis in Light of the Financial Crisis

Abstract

This essay examines a particular form of executive compensation—to wit executive incentive compensation paid in cash, a compensation practice susceptible to particular forms of moral hazard and conflict of interest. Beginning in 2007 and continuing throughout 2008 and 2009, many firms in the financial services industry incurred enormous losses while in the years immediately preceding this deluge of losses, many executives received substantial cash-based compensation. Cash-based incentive compensation is largely based upon measures of short-term earnings, earnings which may not fully reflect substantial risk-taking, the outcome of which remains uncertain at the time that risk-free cash bonuses are paid. The substantial divergence of economic outcome between shareholder and executive is the focal point of the analysis here. The payment of cash-based incentive compensation in the financial industry is examined under several forms of moral reasoning, and in each case moral justification for such practices cannot be found. Further, such practices create moral hazard, conflicts of interest, and unjust outcomes.

Key Words: Executive Compensation, Financial Crisis, Bonuses, Cash-Based

Compensation

Cash-Based Executive Incentive Compensation and Net Earnings: Ethical Analysis in Light of the Financial Crisis

2.1 Introduction

Executive compensation has been the subject of inquiry and analysis by ethicists, financial economists, and other academics for decades (Bebchuk & Fried, 2005b; Moriarty, 2005; Nichols & Subramaniam, 2001; Walters, Hardin, & Schick, 1995). In the wake of the global financial meltdown of 2008, executive compensation in the financial services industry has come under increased public scrutiny from politicians, regulators, and self-regulatory organizations. The Conference Board, for example, has examined changes underway in executive compensation, particularly cash-based compensation (The Conference Board, 2008) and The Federal Reserve Bank of New York has issued a report comparing executive compensation practices at privately held firms with executives at publicly held firms (Cole & Mehran, 2008).

The heightened scrutiny on executive compensation has been fueled in part by a popular sense of outrage that financial executives have profited during a time when the repercussions from the financial crisis of 2008 included many citizens losing jobs and the overall economy struggling. However, the scrutiny is also driven by the belief among many regulators and politicians that executive compensation practices in the financial industry contributed to the collapse of the housing market and the credit crisis that has followed the financial meltdown on Wall Street. As one federal housing

official put it, “misaligned incentives in compensation systems are at the core of the current financial market and housing market linked crises” (Wachter, 2007) .

The analysis in this paper focuses on a particular form of executive compensation—to wit executive incentive compensation paid in cash, a compensation practice susceptible to particular forms of moral hazard and conflict of interest. The focus on executive compensation paid in cash is motivated by the unique set of circumstances which may arise when substantial cash incentives are paid based upon accrual, or non-cash based earnings. Such circumstances provide useful clarity in the context of an ethical examination of executive compensation. Further, as set forth below, the academic literature is replete with examinations, ethical and empirical, with respect to equity-based compensation while the examination of cash-based incentives is an area of research with less focus.

Beginning in 2007 and continuing throughout 2008 and 2009, many firms in the financial services industry incurred enormous losses while in the years immediately preceding this deluge of losses, many executives received substantial cash-based compensation (Palmon, Santoro, & Strauss, 2009). Cash-based incentive compensation is largely based upon measures of short-term profits, profits which may not fully reflect substantial risk taking, the outcome of which remains uncertain at the time that risk-free cash bonuses are paid. The substantial divergence of economic outcome between shareholder and executive is the focal point of the analysis here. The payment of cash-based incentive compensation in the financial industry is examined under several forms of moral reasoning and cannot be justified under any moral theory. Further, such practices create moral hazard, conflicts of interest, and unjust outcomes.

An important input into the annual assessment of CEO performance is the publically reported net earnings of the corporation that the CEO heads. In the financial services industry, this measure, reported net earnings, retains substantial uncertainty with respect to full realization in cash. Given the role that reported net earnings plays in CEO assessment, the very form and essential properties of executive incentives paid in cash creates moral hazard and conflict of interest because of the resultant disjunction of economic interests between CEOs and shareholders.

Moreover, due to the moral nature of the fiduciary relationship that exists between a firm's CEO and its shareholders, the amount of cash compensation paid to CEOs raises significant ethical concerns, particularly in the financial services industry. While the focus of the analysis in this paper is primarily on the moral obligations that CEOs have to shareholders, the analysis is fully compatible with obligations owed to other stakeholders including taxpayers, who are particularly relevant given the public bail-out nature of the U.S government actions to prevent catastrophic failure of the financial system.

Additionally, the ethical aspects of cash-based compensation attributed to the CEO are extendable to other highly paid senior corporate officers with similar moral duties. Such executives also have authority to commit an institution to ongoing business risk and, to a large extent, are also awarded incentive compensation based upon earnings metrics which retain cash realization risk. Finally, regardless of which moral theory is applied, moral justification for the payment of substantial cash bonuses cannot be found in those circumstances when shareholders retain an ongoing economic risk to fully realize the profits which were the basis for the risk-free cash bonuses.

The analysis begins with a review of executive compensation theories and perspectives in the academic literature. This is followed by an empirical examination of executive compensation in the financial industry with a focus on executive incentives awarded in cash in the period immediately preceding the financial crisis. A moral analysis of the duties of fiduciaries with respect to the interaction of incentive payments and executive performance measures, i.e. net earnings, is then developed. Incorporating both an ethical perspective (Boatright, 1994; Marcoux, 2003; Moriarty, 2009) as well as an economic and legal perspective (Easterbrook & Fishchel, 1991), the analysis is developed that the moral nature of the fiduciary relationship between boards, compensation committees, CEOs, other senior executives, and shareholders gives rise to special considerations with respect to the nature of executive compensation. Finally, moral theory is applied to an examination of the cash bonuses. While in this paper the focus of analysis is the impact of cash-based executive compensation on the moral duties that fiduciaries have to shareholders, the analysis is broadly compatible with similar duties that might be owed to other stakeholders (Evan & Freeman, 1993).

2.2 Literature Review

2.2.1 Executive Compensation - Equity-Based Incentive Compensation

Companies implement executive compensation packages to attract, retain, and motivate talented executives (Zajac & Westphal, 1995). In the financial industry, executive compensation generally consists of an annual base salary component and an executive incentive compensation component. While base salary is normally paid in

cash, performance incentives can take a variety of forms which broadly fall into the categories of equity or cash.

Equity-based (i.e. stock-based) incentive compensation awards provide executives with shareholder-like economic interests in a company, giving them a direct personal financial interest in the future appreciation of a corporation's stock price. This direct personal economic interest in the future appreciation of the stock price represents a crucial point of alignment with shareholders' economic interests. Both groups—executives and shareholders—share a linked common economic interest.

Equity-based incentive compensation awards exist in several forms, including restricted stock, restricted stock units (RSUs) and stock options grants. While not devoid of ethical complications such as backdating of options and spring-loading of options, equity-based executive compensation has, as a practical matter, become broadly accepted by companies as a means of aligning the interests of shareholder and management.

2.2.2 Executive Compensation -Bonuses and Non-Equity Incentive Compensation

In addition to equity-based incentives, cash-based incentives are awarded to executives. Under applicable SEC regulations, cash-based incentives paid to corporate executives may be characterized as either “non-equity incentive compensation” or “bonus.” These are the two publicly reported categories of executive incentives paid in cash. In connection with soliciting the voting proxy of shareholders to be exercised at annual meetings where directors will be elected, Securities and Exchange Commission (SEC)-registered companies are required to file proxy statements which, among other

disclosures, report compensation information for the most highly paid executives. The term “non-equity incentive plan compensation” was formally introduced in 2006 by the SEC in the regulations amending required disclosure of executive compensation in financial statements included as part of the proxy statement (Securities and Exchange Commission, 2006). The principal modifications of the 2006 executive compensation disclosures involved changes to the reporting of equity-based compensation. However, the revised disclosures added a requirement that a new category, “non-equity incentive plan compensation,” be incorporated into the summary compensation table presented in the annual Proxy Statement.ⁱ This new category was designed to capture executive incentives awarded in cash which are based upon specific pre-established incentive compensation plans that establish annual performance goals for executives. To the extent that cash incentives are not specifically linked to specific pre-established performance-based incentives, they continue to be reported in the annual “bonus” category. Prior to these rule changes, all annual cash incentive payments awarded to executives were reported in the Summary Compensation Table as the “bonus” component of annual compensation.

It should be noted that because many executive incentive compensation plans in the financial services industry are not linked to specific pre-established performance-based incentives, a number of firms have continued to report cash-based executive incentive awards as bonuses. For example, the 2008 Annual Proxy for JPMorgan Chase includes the following as a footnote to the Summary Compensation Table:

The plan allows the Compensation Committee substantial discretion, which the Compensation Committee uses consistently in establishing compensation

following the completion of a fiscal year. Accordingly, we report amounts paid under this plan as “bonus” and not “non-equity incentive compensation. (Chase, 2008)

In this article the term “cash incentives or cash-based compensation” is used to include amounts that are reported both as “non-equity based incentive compensation” as well as amounts that are classified as “bonus.” This is due to the fact that both forms of cash compensation raise ethical issues which are the focus of this paper since the relevant disjunction between the economic interests of shareholders and management occurs regardless of whether the cash compensation was awarded pursuant to a pre-existing plan or as a bonus determined after the reporting of a company’s financial performance.

2.2.3 Performance and Pay

Prominent theoretical scholarship on executive compensation includes work in the economics and management literature and is based upon classic economic agency theory. This stream of scholarly work examines the thesis that the inherent conflicts between the economic interests of the agents and the economic interests of the principals can be solved through the adoption of enforceable corporate governance mechanisms that incentivize and/or constrain managers’ interests such that shareholders are provided with some assurance that their best economic interests are pursued by managers (Jensen, 2002; Jensen & Meckling, 1976). Various mechanisms have been developed as part of the solution to this agency problem and these mechanisms can broadly be described as the set of corporate governance mechanisms. Important

corporate governance mechanisms that are in place today and have been the subject of academic work include CEO compensation, boards of directors, audit committees and independent audits, and shareholder rights (Larcker, 2007; Jensen and Murphy, 1990; Coates, 1990). It is this set of mechanisms that is designed to mitigate the agency problem that exists between the management of modern day, publically listed firms and the shareholders of these firms and to provide shareholders with assurance that their best economic interests are being protected and pursued.

Executive incentive compensation, both equity-based and cash-based, is an element of such interest-aligning corporate governance mechanisms and provides performance-based bonus opportunities for executives. A CEO's self-interest may be altered by substantial equity interest in a firm. Under such circumstances the personal interests of CEOs become steward-like as opposed to a personal interests which are purely agency interests (Wasserman, 2006).

There is substantial research in support of the effectiveness of equity-based compensation as well as cautionary work which identifies risks that may exist with respect to equity-related incentive compensation. Academic research remains inconclusive with respect to the effectiveness of equity-linked compensation as an effective incentive mechanism (Daily & Dalton, 2002; Erickson, Hanlon, & Maydew, 2006). Issues examined include raising shareholder awareness with respect to the possibilities that self-interested executives, with private information about a firm, and who hold options, have incentives to reveal positive information about the firm, but not negative information (Barth, 2003). Additionally, studies have linked the retraction and restatement of financial statements as well as fraud to equity-based compensation

(Denis, Hanouna, & Sarin, 2006). Other issues identified by researchers include options back-dating (Alexander, Hirschey, & Scholz, 2007; Heron & Lie, 2007). While performance-based equity incentives have achieved widespread acceptance in the corporate world, important issues related to the vesting and cash-out terms of equity awards continue to raise significant corporate governance concerns (Bebchuk & Fried, 2009). The case of former Countrywide Financial CEO Angelo R. Mozilo highlights the potential abuses of the issuance of stock options. As Nell Minow of The Corporate Library noted in her 2007 testimony before the United States House of Representatives Committee on Oversight and Government Reform:

Over the last few years, CEOs at companies involved in the subprime mess received excessive compensation largely based on performance measurements linked to inflated earnings targets... by the end of 2007, when Countrywide finally revealed the losses it had previously obscured, shareholders lost more than 78% of their investment value. Meanwhile, in early 2007 Mr. Mozilo sold over \$127 million in exercised stock options before July 24, 2007, when he announced a \$388 million write-down on profits. (Minow, 2007)

A well-developed body of literature has focused on “pay without performance.” Within the context of the agency problem, Bebchuk and Fried 2003 and 2005, have developed the managerial power perspective, which argues that the nature of executive compensation arrangements may reflect managerial rent-seeking as opposed to the design of efficient incentives (Bebchuk & Fried, 2003; Bebchuk & Fried, 2005b). Rent-seeking managers seek disproportionate compensation which is not based on performance. Further, Bebchuk and Fried as well as Bebchuk and Grinstein, have

examined a number of situations which raise serious concerns and highlight problems with executive pay and the relationship to corporate performance. These include an examination of the Fannie Mae compensation debacle (Bebchuk & Fried, 2005a), an examination of compensation stealthily camouflaged as retirement benefits (Bebchuk & Fried, 2004), as well as an empirical and theoretical examination of the disproportionate rise in equity-based compensation relative to performance, firm size, and industry (Bebchuk & Grinstein, 2005).

Other scholars have offered alternative theoretical formulations to the Bebchuk and Fried managerial power framework. Core, Guay and Thomas (2005) argue that sub-optimal contracting results more from inefficient pay structures than from managerial rent seeking—or at least the empirical evidence they present can be interpreted in such a fashion. Researchers have also examined excessive executive compensation, particularly excessive total compensation (Nichols & Subramaniam, 2001; Walters, Hardin, & Schick, 1995).

2.2.4 Pay for Illusory Performance

In this paper, the existing executive compensation literature is extended by examining, from an ethical perspective, the interaction of performance measures and executive incentives, specifically cash-based incentives. This examination in this paper is not concerned per se with the phenomenon of “pay without performance”. A more accurate description of this examination would be an ethical analysis of pay for illusory performance.

While the total amount of compensation an executive is paid remains fundamental to the questions raised, the focus here is not on excessive compensation in the sense of the value of an executive relative to a benchmark. Rather, the targeted emphasis is on the non-equity component of executive compensation, with the objective of analyzing the implications of economic risk transference which occurs with such non-equity incentives.

The ethical argument is a simple but compelling one. If performance is measured by net earnings, the full cash realization of which is uncertain, then executive incentive compensation would best align with earnings if such compensation continued to reflect such uncertainty. As further developed in the moral analysis section below, these potentially divergent outcomes raise moral hazard and conflict of interest issues and may have contributed casually to the financial crisis. Before the development of the ethical analysis, empirical data relevant to cash realization risk in the years leading up to financial crisis of 2008 is presented.

Seven major financial services firms failed during the period from March 2007 through October 2008. These firms—AIG, Bear Stearns, Countrywide, Lehman Brothers, Merrill Lynch, Wachovia and Washington Mutual—either went into bankruptcy, were taken over by the US Government, or were subsumed into the operations of larger solvent financial institutions. Table 1 presents the total cash incentive payments made to the top five senior executives at these failed firms during the years 2006 and 2007, the years immediately preceding the meltdown of the financial industry. As shown in Table 1, a total of \$493.2 million of executive incentive compensation was paid in cash, over two years, to the five top executives at the seven

firms that failed. The average cash payment to the top five executives exceeded \$14 million, with the largest two-year total paid to one executive in excess of \$40 million. For each firm, the table summarizes compensation data as disclosed in the respective Annual Proxy statements.

Table 1.1 - Total Cash Incentives for the Top Five Senior Executives at Each Firm

Firm	2006 Cash Incentives	2007 Cash Incentives	Total
AIG	\$42,600,000	\$32,600,000	\$75,200,000
Bear Stearns	\$52,300,000	\$71,600,000	\$123,900,000
Countrywide	\$40,100,000	\$34,700,000	\$74,800,000
Lehman Bros	\$38,100,000	\$23,500,000	\$61,600,000
Merrill Lynch	\$48,800,000	\$66,900,000	\$115,700,000
Wachovia	\$18,000,000	0	\$18,000,000
Wash. Mutual	\$13,000,000	\$11,000,000	\$24,000,000
Total	\$252,900,000	\$240,300,000	\$493,200,000

Table compiled from respective Annual Proxy Statements.

In addition to the cash compensation, these executives received equity-based compensation of approximately \$685 million for the two-year period 2006 to 2007. While the equity incentives awarded to executives in these instances did not create

better performance for shareholders (Fahlenbrach & Stulz, 2011), the cash incentives awarded raise additional questions and issues, including how and why the levels of cash-based incentive compensation increased to such substantial levels.

The finding that cash compensation and equity incentives were roughly equal among the failed firms corroborates the findings of earlier research. Bebchuk and Fried (2005), for example, report:

Although the equity-based fraction of managers' compensation has increased considerably during the past decade and has therefore received more attention, non-equity compensation continues to be substantial. In 2003, non-equity compensation represented on average about half of the total compensation of both the CEO and the top five executives of S&P 1500 companies not classified as new economy firms. (2005b)

Indeed, a review of the proxy statements for leading financial services firms (Bear Stearns, 2004-2008; Lehman Bros Holding, 2004-2008; Merrill Lynch Inc., 2004-2008) reveals that, within the financial services industry and more narrowly within the investment banks, the rate of growth of equity-based compensation often exceeded the rate of growth of executive incentives paid in cash. However, while equity-based compensation increased, it was often the case that equity-based compensation was incrementally added to the cash incentives as opposed to being considered either a full or partial replacement. Consequently, given the growth in earnings of the investment banks over the past decade, both components of incentive compensation grew substantially.

The preliminary analysis is based upon the relationship of the performance measure—net earnings, and the cash incentives paid based on such performance measure during the years immediately preceding the financial crisis. In the years leading up to the financial crisis, reported net earnings was an important performance measure in the determination of cash-based compensation for the CEO of financial services firms. Table 2, which presents raw data for Bear Stearns, illustrates this point.

Table 1.2: Cash-Based Compensation as Percentage of Net Income

	2004	2005	2006
Bear Stearns Net Income	\$1,317,000	\$1,438,000	\$2,033,000
CEO total compensation	\$27,000	\$38,200	\$38,400
CEO cash-based compensation	\$10,100	\$12,700	\$17,000

Note. In millions of dollars

For the fiscal year 2007, Bear Stearns reported profits of \$212,000. As of January 12, 2007, the price per share of Bear Stearns' stock was \$171.00. By March 2008, Bear Stearns was no longer viable as an independent firm and was acquired by JPMorgan Chase for approximately \$10.00 per share, reflecting the evisceration of over 90% of shareholder equity over a period of 14 months. While the specific result for each of the failed firms is unique, the overall circumstance for each firm is similar to the Bear Stearns circumstances: a period of substantial and increasing profits accompanied by incentive awards based upon net earnings, followed in 2008 by the failure of the firm and a substantial loss to shareholders.

2.3 Ethical Analysis

2.3.1 Paper Profits and Cash-Based Compensation: Misaligned Interests Resulting From Timing and Risk Allocation

The payment of executive incentives in the financial services industry is based largely upon one key performance benchmark—firm profits. As noted, however, executives are paid in cash, restricted stock, RSUs, and stock options, each of which has different timing characteristics. Restricted stock, RSUs, and options are not realized or available as compensation by an executive until a period of years, known as the vesting period, transpires. Cash, however, is realized by the executive when awarded.

The profits which form the primary basis for the incentives award to executives are the publically reported net earnings of a firm. The argument is developed here that awarding cash bonuses on these earnings creates moral hazard and the misalignment of interest because executives benefit with immediate cash rewards while shareholders continue to be exposed to economic risks inherent in the “paper profits” recorded in the company’s accounting.

Reported earnings reflect the putative value for the financial assets that a firm owns. These financial assets, including mortgage-backed securities, have real associated economic risks related to the ultimate realization in cash of the carrying value of these securities. The values of these financial assets that are reflected in the reported earnings are based to a large extent on estimates of the future realization in cash of the value of the asset. To the extent executives were paid both base salary and incentive awards in cash, they became immunized against how these particular economic risks would unfold.

The term “paper profits” highlights the fact that an ex-post earnings announcement economic risk—one which fully surfaced in the recent crisis—is the risk that a firm will not fully realize in cash the amount of earnings which were reported and which were the basis for the determination of executive incentives. In such circumstances, earnings quality is suspect and raises concerns with respect to the use of net earnings as a benchmark for the determination of cash-based incentives.

Critically important is that in this financial crisis, ex-post, the full cash realization of firms’ earnings and most notably the mortgage-backed securities valuations have turned out to be fictional—fictional in the sense that substantial components of the reported earnings and asset values were never in fact actualized, meaning never realized in cash. Cash was never realized because certain business, accounting, and economic estimates and judgments that were used in the determination of reported earnings and asset valuations ultimately, in fact, turned out quite differently. Consequently, these circumstances have contributed to the substantial losses that many financial institutions have recently reported. The reported net earnings turned out in fact to be illusory. Rather, substantial losses were reported in subsequent periods to account for the fact that, among other items, the carrying value of assets was not going to be realized in cash.

As additional background, it is also important to add that one element of the rationale for awarding cash incentives on reported earnings, which were not yet actualized in cash, is that Generally Accepted Accounting Principles (GAAP) provided the rules and principles for the formulation of reported earnings. Very generally, these accounting principles and rules are designed to be conservative, which implies that

reported earnings would reflect activities that one could reasonably be assured would be realized in cash. Given the various economic and accounting assumptions that underlie reported earnings and related asset valuations, and what has been learned about the uncertainty in the risk profile of financial institutions and how wrong those assumptions can be, there may always be risks with respect to earnings realization that cannot be accurately estimated. As in the case of the financial firms that failed, these risks were substantial and significant and unfolded such that shareholders suffered major losses.

With equity-linked incentives, the on-going economic risks associated with reported earnings are shared by management and shareholders. Namely, the stock price of a company adjusts to new information, and both shareholders and executives with equity-based compensation gain or lose. When, conversely, executive incentives are paid in cash on earnings which later prove to be illusory, there is a fundamental disjunction of interests between shareholders and management (Story, 2008). With executive cash compensation, management benefits with the rewards, but the shareholders continue to be exposed to the economic risks.

2.3.2 Moral Aspects of Fiduciary Duties

At public corporations, fiduciaries, namely boards and compensation committees, are responsible for executive incentive compensation decisions. In recent years a number of scholars have examined the nature of the fiduciary duties owed to shareholders, and they have argued that such fiduciary duties to shareholders include a moral dimension that extends beyond that which is legally required of them. In addition to the duties of boards and compensation committees, the duties of CEOs are considered

to be quite different and more extensive than those of ordinary workers who do not have the same fiduciary duties to shareholders. The analysis below also examines which senior executives, other than the CEO, might owe similar duties.

Boatright (1994) examined shareholder-management relations and posed a simple question: what is so special about shareholders? While the question is a simple one, his answer was considerably more subtle. He argued that unique aspects of the shareholder-management relationship lead to the creation of fiduciary duties for executives. Boatright's argument that the rights of shareholders advance a broader social and public policy agenda rests, in part, on the classic work of A. A. Berle in the 1930s (Berle & Means, 1932). As Boatright states,

Berle's argument is that corporations ought to be run for the benefit of shareholders, not because they "own" the corporation, or because of some contract or agency relation, but because all other constituencies are better off as a result. The underlying assumption is that the fiduciary duties of management are and ought to be determined by considerations of public policy. (Boatright, 1994)

Public policy, the betterment of all constituencies, is best served, Boatright argues, if corporations are run for the benefit of shareholders. Thus, Boatright's argument for special shareholder rights rests not on shareholders ownership of the company, or on neoclassical agency theory, but rather, his argument rests on an ethical foundation of public policy and the betterment of society in general. While, as noted below, other scholars have developed the moral basis for fiduciary duties through fundamentally

different arguments, Boatright's theory does provide scholarship which supports the alignment of shareholder interests and the public interest.

Marcoux (2003) also argued that shareholders occupy a special moral status that justifies the fiduciary duties owed to them at law by managers (Marcoux, 2003). However, Marcoux did not ground the morality of executive fiduciary duties in public policy consideration as Boatright does. Instead, Marcoux argued that the moral relationship derives from the essence of the relations between the parties. Analogizing from other examples of fiduciary relations such as doctors and patients, attorneys and clients, guardian and wards, Marcoux argued that "fiduciary relations constitute a special class of moral relations where the duties of one party to a relationship are enhanced or extended by the vulnerability of the other party" (2003). For Marcoux, vulnerability includes not only physical, mental, or financial vulnerability, but also "deficits of control and information that arise from the relationship" (2003). Marcoux hastened to add that "vulnerability alone, i.e., in the absence of a special undertaking on the part of one or both of the parties, does not give rise to a fiduciary obligation or relation" (2003). However, he argued that when one enters into a relationship with a vulnerable person, one assumes special obligations that go beyond what one might encounter in ordinary relationships between parties that are not in a fiduciary relationship. Marcoux concluded: "If I transact with another in a situation in which she has all of the relevant knowledge and virtually all control over my assets, both the law and the moral intuitions supporting it suggest that she exercise a special duty of care for my interests" (2003).

In *The Economic Structure of Law*, Easterbrook and Fischel (1991) approached their analysis of the fiduciary relationship between a CEO and shareholders from an economic and legal perspective, concluding that, due to the position which shareholders hold as residual claimants, shareholders are in the best (not perfect) position to monitor and discipline executives (Easterbrook and Fischel, 1991). As they stated, residual claimants “bear the marginal risk of the firm and so have the best incentives to make the optimal investment and management decisions.” This special relationship, they emphasized, benefits from the protection of fiduciary principles and a promise from CEOs for hard work and honesty. The moral dimension of the fiduciary duty of CEOs is recognized in the honesty emphasized by Easterbrook and Fischel.

Building on the work of Boatright, Marcoux, and others, Moriarty (2009) argued that the moral nature of the CEO-shareholder fiduciary relationship imposes a moral duty on CEOs to self-limit the overall amount of their own personal executive compensation. While Moriarty acknowledged that his conclusion regarding CEO self-limiting pay is controversial and not universally shared, the basis for his conclusion rests on the premise that “Executives are fiduciaries in a moral sense, i.e., that their fiduciary duties are moral in character” (Moriarty, 2009).

2.3.3 Moral Hazard to Moral Failing: The Moral Duties of Fiduciaries Regarding Cash-Based Compensation

Based on the foundation of the moral nature of fiduciary duty, the analysis shifts to moral hazard, which describes the disjunction of interests between the principals (in this case, the shareholders) and their agents (in this case, the executives). When one

party exercises power over another's wealth, moral hazards arise. The moral hazard and misalignment of interest problem with cash-based executive compensation arises from the fact that cash incentives are paid in a given fiscal year on the basis of reported earnings that might never come to fruition for shareholders. Further exacerbating the circumstances is that the earnings may have resulted from an increase in the risk profile of the institution. The misalignment of interest is clear even in the absence of nefarious intentions, and the moral hazard creates potentially perverse incentives for executives to pursue reported earnings that, ex-post, may never be realized in the form of cash by shareholders in a later fiscal year when the business risks that created the profits will be written down or restated. However, moral questions of fiduciary duty arise, even in the absence of such misaligned motivations, when earnings subject to cash realization risks turn out, as they did during the financial crisis, to be illusory.

The substantial levels of pay, combined with the failures of major financial intuitions, have generated an urgent interest in reexamining the ethical dimensions of executive pay. Clearly the compensation system adopted by the firms is full of moral risk, and some of these risks were only fully exposed by the financial crisis. The fiduciaries—boards, compensation committees, as well as CEOs—by virtue of the moral dimension of their fiduciary duty to shareholders, have a moral obligation to balance the nature of the performance measure with the nature of pay to ensure that the form of an executive's compensation is aligned with the risk profile of the shareholder. Compensation arrangements which immunize CEOs from the risks of cash realization of earnings are so fraught with moral hazard that each fiduciary in the relationship with

shareholders can be said to violate fiduciary and moral duty owed to shareholders occurred.

Specifically with respect to CEOs—the executives who, by virtue of extensive access to private information about a company, are the most knowledgeable about a firm’s business risks—an important consideration is under what conditions an executive has a fiduciary-based moral duty to ensure that the form of the executive’s compensation is aligned with the risk profile of the shareholders. Fiduciary duties apply when individuals have a strict duty to act in the best interests of the person to whom the duty is owed. This would include avoiding circumstances in which there is the possibility of those interests conflicting. Therefore, whether or not a fiduciary has a moral duty to ensure that cash incentive payments reflect earnings risk would depend on whether the fiduciary reasonably believes that earnings risk exists.

Two situations are postulated: (1) no earnings risk; (2) existence of a cash realization earnings risk. The first condition, where there is a reasonable ex-ante belief that no earnings risk exists, yields a clear moral result. If at the time that cash incentives are paid, there is a reasonable belief that no cash realization earnings risk exists, then the payment and acceptance of cash-based incentives would be consistent with the moral analysis here. It should be noted that the moral status of cash compensation in this instance does not change if in fact it later turns out that there was an underlying risk that was not sufficiently appreciated at the time of the cash compensation. What matters is that the fiduciaries involved in the compensation decision reasonably believed that *at the time the cash compensation was paid* the earnings risk either did not exist or was quite remote.

In the second condition, there is a reasonable ex-ante belief that cash realization of earnings risk exists. If at the time executive cash incentives are awarded fiduciaries have some understanding or knowledge of probable or even possible cash realization earnings risks, then moral duties would clearly be violated. In this circumstance the fiduciaries, including the CEO and other executives, would owe a duty to stockholders and stakeholders to ex-ante limit cash incentives while shareholders retain substantial economic risk. Specifically related to the credit crisis, the accumulation of substantial subprime loans and investments, while producing short-term profits in the years immediately preceding the financial crisis, radically altered the risk profile of many financial institutions. These risks remained on the balance sheet and ultimately materialized as write-downs or losses of assets held. CEOs, more than any other executives, would have the access to information to best understand these dynamics.

One could argue that there is almost always some uncertainty surrounding the full realization of earnings. There are no doubt shades of gray possible here. How much true uncertainty there is about the underlying risk shifting to stockholders is an important question. The moral calculus is further complicated by the fact that executives faced with the prospect of cash incentive compensation have a strong incentive to underestimate the underlying risks in the transaction.

2.3.4 Extending Moral Duties to Self-Limit Cash Compensation Beyond CEOs to Other Corporate Executives

As illustrated by the compensation data disclosed in Annual Proxy Statements, today's complex corporations have numerous highly compensated senior executives

who share responsibility for the management of the enterprise. The interest of shareholders would be best served if the legal and moral fiduciary duty clearly and unambiguously extended beyond the CEO to other senior executive officers who not only are highly compensated, but who also clearly have authority for significant business decisions.

The rationale for extending the moral analysis in this paper to the most highly paid executives in a firm beyond the CEO is based on factors which, as discussed earlier, also impact the board, compensation committee, and CEO. Furthermore, the scope of duties of senior executive officers includes the ability to commit the organization to business transactions, including transactions involving ongoing risk. As in the case of the CEO, the question of performance measurement is a question of understanding ongoing open business risks. As a practical matter, the alignment of cash incentives among all senior executives will better protect shareholders. To further appreciate why it is appropriate to broaden the class of senior executives with potential fiduciary duties, the example of the compensation practices described in Table 3 is presented. Table 3 is an actual 2004 compensation table from one of the failed firms. While the CEO was not awarded a cash-based incentive, the awarding of cash incentives to other top executives continues to expose shareholders to the moral hazard issues discussed in this paper.

Table 1.3: Compensation -Top Five Senior Executives

	Salary	Cash Bonus	Stock Bonus
CEO	2.2%	0.0%	97.8%
Top Executive	1.6%	48.4%	50.0%
Top Executive	2.1%	47.9%	50.0%
Top Executive	2.3%	47.7%	50.0%
Top Executive	2.3%	47.7%	50.0%
Top Executive	2.7%	47.3%	50.0%

2.3.5 Moral Theories

The examination of cash-based incentives is finalized with a moral analysis of risk-free, cash-based executive incentives which draw upon leading moral theories: deontology, justice and fairness, and virtue ethics.

During the post-World War II period, when financial markets, stock prices, housing prices, and the economy were reliably heading in a positive direction, the disjunction of interests which risk-free, cash-based incentive arrangements cause could have been obscured. It is the financial crisis that lays bare the reality of the substantial risks that financial institutions undertook in generating short-term profits and the harm that was generated as these risks materialized into massive and destructive losses.

Kantian moral calculus centers on rational motivation and duty. Human actions are judged to be moral if they are based on a rational motivation which is derived from one's sense of duty (Bowie, 1998; Bowie, 1999). Duty, in part, is rooted in universal acceptance. In the case of CEOs and compensation committee members, who possess requisite knowledge of the business of the firm, the profits and the relationship between business risk and compensation, undertaking compensation arrangements which foster misalignment of interests between shareholders and executives, raise fundamental questions as to whether executives' short-term self-interests have overtaken shareholder interests. Systemic adoption of such arrangements could undermine the entire agency relationship which provides shareholders with confidence that their interests are being looked out for. Further, questions, consistent with Kantian analysis, can be raised regarding using people—in this case, shareholders as means, not ends.

For Rawls, evaluating just outcomes requires beneficiaries of economic gain to consider the impact that their actions have on the least well-off members of society. Specifically, the Rawlsian difference principle, the second part of Rawls's second principle of justice, permits only those economic and social inequalities which would benefit the least advantaged member of society (Sandel, 2009).

Again, shifting economic realities, combined with a deeper understanding of the nature and explosiveness of the business risks undertaken by major financial firms, adds important information to the moral analysis. A compensation system that rewards a few who undertake reckless decision-making by rewarding short-term profits while

accumulating risks not only does not benefit the least well of members of society but, as we now know, creates substantial harm.

The Rawls difference principle rests upon the belief that inequalities of wealth and income work to the advantage of those who will be worst off (Frazer, 2007; Rawls, 1999). During years of economic growth and access to affordable housing, false confidence may have emerged that compensation arrangements at financial institutions were indeed benefiting the masses; the painful realities of the financial crisis of 2008 have laid bare a strikingly different reality.

Finally, virtue ethics focuses on moral character rather than motivations or consequences. Again here, to best examine this question we expect that board members, compensation committee members, and CEOs have good information regarding the business that they have fiduciary responsibility for. One important question to be considered is: to what extent did raw self-interest and greed result in a situation where the drive for short-term profits overwhelmed other considerations, including prudent risk-taking? Would a virtuous person, with a deep, committed understanding of the responsibilities to shareholders have taken a different view (Solomon, 1992, 2003)?

2.4 Social Historical Context

It is important to note that the overall context for this paper is the pre-existing and ongoing market-based capitalistic system of the U.S. One central assumption is that the economic, social, political and financial systems of the U.S. today are sustainable and built to last. There is, however, an alternate view: that capitalism itself

is not sustainable and that the financial crisis is prima fascia evidence of cracks in an economic, social, and political system that inevitably will collapse. In fact, some, including Marx, have argued that capitalism is fundamentally flawed as a sustainable system and that consequently there is inevitability to its collapse. Marx argued that the conflicts generated in a capitalistic system would undermine the sustainability of the system (Schumpeter, 1994). As a comprehensive examination of this school of thought is not intended here, it should merely be noted that one limitation of this essay is that the analysis rests on the presumption of the sustainability of the U.S. socioeconomic system. Consequently, it is acknowledged that the universal applicability of the analysis in this dissertation is limited by the assumptions adopted.

Furthermore, with respect to the moral and ethical values which exist within a society at a given time, it is also acknowledged that such values are not necessarily intrinsically of the highest order. While Ollman more fully develops the understanding of a Marxian ethics, he also characterizes the understanding of Marxian ethics as follows:

(1) Moral values change; (2) they change in accordance with society's productive forces and its economic relations; the dominant moral values at any given time are those of the dominant economic class. (3) As part of this case, concepts, such as "good," "right" and "justice", are shown to derive their very meaning from the conditions of life corresponding interests of men who use them. (Ollman, 1973)

The ethical analysis in this essay approaches the topic of ethics from the perspective that the sustainability of the social, political, and economic systems is desirable. The

explicit case for this is not developed. Strongly influenced by Rawls, Kant, Bentham, and Aristotle, the moral perspective which guides the analysis in this essay is that which forms the norm of modern business ethic scholarship. While such norms represent the efforts of today's leading business ethics scholars, such norms are not immune to the criticisms attributed to Marx above, and such is an acknowledged limitation of this essay.

2.5 Conclusion

With respect to cash-based incentive compensation, given the uncertainties which generally exist with respect to the cash realization of reported earnings of companies, this essay has suggested that whether examined from the perspective of executive compensation and agency theory or an ethical analysis of fiduciary duties or fundamental moral theory, no moral justification can be found for rewarding substantial cash bonuses awarded on short-term profits while significant uncertainty and risk remains in the business—risks which shareholders bear. If no moral basis can be established for substantial cash bonuses, and raw greed is a core value at leading financial institutions, what other practices are morally flawed? What ethical mores are at work in these vital and esteemed institutions? There may be no more important lodestone in the financial industry than compensation, and what conclusions can be drawn if essential moral principles cannot be applied to this central practice?

Yet the analysis can be useful because it exposes the perspective that these institutions adhere to business practices which are difficult to justify ethically. The absence of a moral theory which can be applied to the compensation arrangements

discussed in this paper reinforces the need to more fully examine the behavior of institutions through a moral compass.

More careful empirical study is necessary before a firm causal link can be established between such cash compensation and the financial crisis. Did CEOs and other high-ranking executives take advantage of GAAP rules and principles that allow for the recognition of earnings which will only be collected in cash in the future by aggressively developing businesses with high risks, high earnings, and deferred cash collection—knowing all the while that they personally stood to gain substantially based upon a misalignment of performance measures with the nature of the incentive compensation they were awarded? Did such unscrupulous behavior actually occur and contribute to the financial crisis?

This analysis also has implications for the future of compensation in the financial industry and possibly to other industries where cash constitutes a large portion of executive incentive compensation. It is interesting to speculate about how the culture, business strategies, and day-to-day operations of Wall Street would change if firms adopted limits to cash-based incentive compensation. How would such a system, where the overwhelming majority of executive compensation was paid in equity, impact long-term firm values? Would business risk decisions change? Would, for example, the traders of mortgage-backed securities change their approach if they were not paid, largely in cash, on the paper profits their desk produces? How would these changes affect shareholder value? Additionally, aligning the timing and availability to cash out equity awards with the risk profile of the business may provide further protections to shareholders.

Data has been presented demonstrate the significance and prevalence of cash compensation among the major financial institutions that failed in the recent financial crisis. The analysis presented attempted to demonstrate that the timing imbalance between the realization in cash of the performance benchmarks which were the basis for the incentives and the payment of the cash incentives present important corporate governance challenges and also represent a tempting possibility of abuse by unscrupulous executives.

Consistent with the central argument in this paper, several recent developments indicate that, with respect to cash-based compensation, an emerging new approach is being undertaken by companies and policy makers. For example, Goldman Sachs has announced that for 2009, the top 30 executives of the company will be subject to a cap on the amount of cash bonus they may receive. The press release stated all 30 members of the management committee:

will receive 100 percent of their discretionary compensation in the form of Shares at Risk, which are subject to restrictions for five years. Discretionary compensation represents the vast majority of senior management's compensation and is directly tied to the firm's overall performance. (Goldman Sachs, 2009)

Another development, consistent with a keen public focus on cash compensation, is that U.S. Compensation “Czar” Kenneth Feinberg has announced several new limitations on compensation for firms that operate under the Treasury’s TARP program. These limitations include a rule that at least 50% of an employee's compensation must be long-term and held for three years or more. Additionally, for

2009 a limit of cash compensation of \$500,000 will be put in place and the total of cash compensation must not exceed 45% of total compensation (Solomon & Holzer, 2009).

As one speculates on the future of cash-based incentive compensation on Wall Street, it is important to keep in mind several salient facts about the financial industry. First, it is only in the past three decades that Wall Street financial firms have become publicly held. Thus it is a relatively new phenomenon for the executives of these firms to be accountable to public shareholders for their risk allocation decisions and the relationship of these risk decisions to compensation. The absence of a moral justification for such bonuses raises concerns regarding the values and behaviors of financial intuitions, concerns which an ethical society will inevitably be drawn to.

Finally, a point that bears noting is one of the most important lessons that we have learned from the financial crisis: i.e. that because of their sheer size and interconnectivity, a large number of financial institutions are systematically and significantly connected to the financial markets and the entire economy (Summers, 2008). Thus, when they fail, they put the entire financial market under stress. Indeed, as has been learned, when these financial institutions fail they can have a ripple effect on the entire global economy. This systemic connection to markets and economies makes the issue of cash-based compensation one of great public import.

Footnotes

i- Annual Proxy Statement: The SEC requires that shareholders of a company whose securities are registered under Section 12 of the Securities Exchange Act of 1934 receive a proxy statement prior to a shareholder meeting, whether an annual or special meeting. The information contained in the statement must be filed with the SEC before soliciting a shareholder vote on the election of directors and the approval of other corporate action. Annual Proxy Statements are required to include a section on executive compensation which includes a compensation table.

References

- Alexander, R. M., Hirschey, M., & Scholz, S. (2007). Backdating employee stock options: Accounting and legal implications. *CPA Journal*, 77(10), 19-23.
- Barth, M. E. (2003). Discussion of "Compensation policy and discretionary disclosure". *Journal of Accounting & Economics*, 34(1), 311-318.
- Bear Stearns. (2004-2008). Annual Proxy Statements.
- Bebchuk, L., & Fried, J. (2009, June 16). Equity compensation for long term results. *Wall Street Journal*.
- Bebchuk, L., & Grinstein, Y. (2005). The growth of executive pay. *Oxford review of economic policy*, 21(2), 283-303.
- Bebchuk, L. A., & Fried, J. M. (2003). Executive compensation as an agency problem. *Journal of Economic Perspectives*, 17(3), 71-92.
- Bebchuk, L. A., & Fried, J. M. (2004). Stealth compensation via retirement benefits. *Berkeley Business Law Journal*, 1, 291-326.
- Bebchuk, L. A., & Fried, J. M. (2005a). Executive compensation at fannie mae: A case study of perverse incentives, nonperformance pay, and camouflage. *Journal of Corporation Law*, 30(4), 807-822.
- Bebchuk, L. A., & Fried, J. M. (2005b). Pay without performance: Overview of the issues. *Journal of Corporation Law*, 30(4), 647-673.
- Berle, A., & Means, G. (1932). *The Modern Corporation and Private Property*. New York: Macmillan.

- Boatright, J. R. (1994). Fiduciary duties and the shareholder--management relation: Or, What's so special about shareholders? *Business Ethics Quarterly*, 4, 393-407.
- Bowie, N. (1998). A Kantian theory of capitalism. *Business Ethics Quarterly*, 8, 37-60.
- Bowie, N. (1999). *Business ethics: A Kantian perspective*. Malden, Mass: Blackwell.
- Chase, J. (2008). Annual Proxy Statement. Retrieved Accessed 29 March 2009. Retrieved from: <http://files.shareholder.com/downloads/ONE/595958507x0x185029/d06cf305-14d6-42a5-a331-dfd1dae540df/69337a1.html>.
- Cole, R., & Mehran, H. (2008). What can we learn from privately held firms about executive compensation? *Federal Reserve Bank of New York Staff Reports*. Federal Reserve Bank of New York.
- Core, J. E., Guay, W. R., & Thomas, R. S. (2005). Is U.S. CEO Compensation Inefficient Pay without Performance? *Michigan Law Review*, 103(6), 1142-1185.
- Daily, C. M., & Dalton, D. R. (2002). The Problem with Equity Compensation. *Journal of Business Strategy*, 23(4), 28-30.
- Denis, D. J., Hanouna, P., & Sarin, A. (2006). Is there a dark side to incentive compensation? *Journal of Corporate Finance*, 12(3), 467-488.
- Easterbrook, F., & Fishchel, D. (1991). *The economic structure of corporate law*. Cambridge: Harvard University Press.
- Erickson, M., Hanlon, M., & Maydew, E. L. (2006). Is there a link between executive equity incentives and accounting fraud? *Journal of Accounting Research*, 44(1), 113-143.

- Evan, W., & Freeman, R. E. (1993). A stakeholder theory of the modern corporation: Kantian capitalism. In Beauchamp & Bowie (Eds.), *Ethical Theory and Business* (4th ed., pp. 75-84). Englewood Cliffs, NJ: Prentice Hall.
- Fahlenbrach, R., & Stulz, R. M. (2011). Bank CEO Incentives and the Credit Crisis. *Journal of Financial Economics*, 99,(1), p11-26.
- Frazer, M. (2007). John Rawls: between two enlightenments. *Political Theory*, 35(6), 756.
- Goldman Sachs. (2009, December 10). *Press release: Goldman Sachs announces changes to 2009 compensation program*. Retrieved from <http://www2.goldmansachs.com/our-firm/press/press-releases/current/compensation.html>.
- Heron, R. A., & Lie, E. (2007). Does backdating explain the stock price pattern around executive stock option grants? *Journal of Financial Economics*, 83(2), 271-295.
- Jensen, M. C. (2002). Value maximation, stakeholder theory, and the corporate objective function. *Business Ethics Quarterly*, 12, 235-256.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, 3(4), 305-360.
- Lehman Bros Holding, I. (2004-2008). *Annual proxy statement*. Retrieved February, 2009, from <http://pro.edgar-online.com/Profile.aspx? ColLeft=75acdace-2e0d-43ab-ab8c-bde7ebb0468c&>.
- Marcoux, A. M. (2003). A Fiduciary argument against Stakeholder Theory. *Business Ethics Quarterly*, 13(1), 1-24.

- Merrill Lynch Inc., C. (2004-2008). *Annual proxy statements*. Retrieved from <http://pro.edgar-online.com/Profile.aspx?ColLeft=75acdace-2e0d-43ab-ab8c-bde7ebb0468c&>.
- Minow, N. (2007). *Testimony before United States House of Representatives Committee on Oversight and Government Reform*. Retrieved from <http://oversight.house.gov/story.asp?ID=1762&>.
- Moriarty, J. (2005). Do CEOs get paid too much? *Business Ethics Quarterly*, 15(2), 257-281.
- Moriarty, J. (2009). How much compensation can CEOs permissibly accept? *Business Ethics Quarterly*, 19 (2), 235-250.
- Nichols, D., & Subramaniam, C. (2001). Executive compensation: excessive or equitable? *Journal of Business Ethics*, 29(4), 339-351.
- Ollman, B.O. (1973). *Alienation: Marx's conception of man in capitalist society*. Cambridge Press. p.44.
- Palmon, D., Santoro, M., & Strauss, R. (2009). Pay now lose later: The role of bonuses and non-equity incentives in the financial crisis of 2007-2008. *The Open Ethics Journal*, 3.
- Rawls, J. (1999). *A theory of justice - revised ed*. Cambridge: The Belknap Press of Harvard University Press.
- Sandel, M. J. (2009). *Justice What's the right thing to do?* Harvard University Press.
- Securities and Exchange Commission, U.S. (2006). *Press release: SEC votes to adopt changes to disclosure requirements concerning executive compensation and related matters*. Retrieved from <http://www.sec.gov/news/press/2006/2006-123.htm>.

- Shumpeter, J.A. (2003) *Capitalism, Socialism and Democracy*. Taylor & Francis e-Library.
- Solomon, D., & Holzer, J. (2009). Treasury restricts pay at four firms. *The Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB126054988133487507.html>.
- Solomon, R. (1992). Corporate roles, personal virtues: An Aristotelean approach to business ethics. *Business Ethics Quarterly*, 2(3), 317-339.
- Solomon, R. (2003). Victims of circumstances? A defense of virtue ethics in business. *Business Ethics Quarterly*, 43-62.
- Story, L. (2008, December 18). The reckoning on Wall Street, bonuses, not profits, were real. *The New York Times*.
- Summers, L. (2008, October 26). The pendulum swings towards regulation. *Financial Times*. Retrieved from http://www.ft.com/cms/s/0/d775399a-a38e-11dd-942c-000077b07658.html?nclick_check=1.
- The Conference Board. (2008). *Top Executive Compensation in 2008*.
- Wachter, P. S. M. (2007). *Testimony before United States House of Representatives Committee on Oversight and Government Reform*.
- Walters, B., Hardin, T., & Schick, J. (1995). Top executive compensation: Equity or excess? Implications for regaining American competitiveness. *Journal of Business Ethics*, 14, 227-234.
- Wasserman, N. (2006). Stewards, agents, and the founder discount: Executive compensation in new ventures. *Academy of Management Journal*, 49, 960-976.

Zajac, E. J., & Westphal, J. D. (1995). Accounting for the explanations of CEO compensation - substance and symbolism. *Administrative Science Quarterly*, 40(2), 283-308.

Chapter 3:

Too Big and Too Interconnected to Fail: Historical and Ethical Analysis of the U.S. Financial System

Abstract

The financial crisis which manifested in the United States in 2008, revealed the extent to which the largest and most interconnected financial institutions in the U.S. had become systematically and significantly interwoven into the entire U.S. and global financial and economic system. When institutions of such size, scale, and interconnectedness fail or falter, the financial system in its entirety reacts with fear and ceases normal operations. The collapse of the entire financial and economic system appears imminent, and a bailout with public funds seems a matter of necessity. This essay presents a historical and ethical analysis of the evolution of too-big-to-fail institutions and also examines how such evolution enabled financial institutions to metamorphose into financial leviathans too big and too interconnected to fail.

Keywords: financial crisis; too big to fail; systemic risk, Longstreth

**Too Big and Too Interconnected To Fail:
Historical and Ethical Analysis of the U.S. Financial System**

3.1 Introduction

The financial crisis which manifested in 2008, revealed the extent to which the largest and most interconnected financial institutions in the United States had become “too big and too interconnected to fail,” i.e. so systematically and significantly interwoven with each other and into the entire U.S. and global financial and economic system that their very survival is seen as essential to public welfare. Concerns about the increasing size and interconnectedness of financial institutions preceded the 2008 financial crisis by decades. As early as 1983, SEC commissioner Bevis Longstreth warned about the “growing interdependence among financial institutions” and the resultant “collateral implications” for the economy and the social fabric of allowing any one such indispensable leviathan to fail. Longstreth’s words, however, went unheeded. Indeed, the events which unfolded in 2008 made clear that several financial institutions in the U.S. had become so big and so interconnected that their failure threatened not only the U.S. economy but also the entire global financial system and economy

This essay is an examination of both the historical and ethical aspects of the too-big-to-fail financial system vulnerability. After briefly describing the evolution of the modern U.S. financial regulatory system in the twentieth century, this article examines the various regulatory and financial system developments that facilitated the creation of financial behemoths which became repositories of systemically dangerous

levels of risk. With a focus primarily on investment banks, the key historical developments which enabled these institutions to grow to the point where their potential failure threatened the entire financial system are examined. The historical analysis developed in this paper argues that beyond a breakdown in economic circumstances, it is important to understand the financial crisis which began in 2008 from a historical perspective. The financial system, as has been painfully learned, does not simply include the institutions that can become too big to fail, but also the regulators and policymakers who are charged with protecting the system.

Informed by historical examination, this paper applies ethical reasoning to the historical analysis and argues that the financial crisis is not only a failure of institutions, regulations, policymaking, and supervision but also a failure of fundamental ethical principles. Questions of moral hazard, moral recklessness, and collective moral agency among numerous actors whose purpose and duty are to protect the financial system are examined. Examining and probing the moral dimension of the financial crisis provides valuable practical insights which can help to reduce systemic vulnerabilities and strengthen systemic governance in the United States and elsewhere in the world.

3.2 Historical Analysis

3.2.1 Background: Overview of Financial Oversight and Regulation in the United States

The financial history of the United States is complex with many significant periods of rapid growth, intermittent periods of financial recession, and dramatic periods of economic contraction—to wit, the Great Depression. U.S. economic

development has been accompanied by the concurrent development of a financial oversight regime which incorporates legislative, regulatory, and self-regulatory measures designed to keep the financial system, safe, sound and competitive.

While there are many other critical components of the U.S. financial system, it can be argued that three essential elements of this post-Depression financial system enabled extraordinary economic growth while preventing financial system collapse: (1) transparency and informational symmetry in the securities markets; (2) detection and prosecution of fraudulent behavior through private actions and criminal penalties; and (3) containment of risk to the overall financial system by attempting to limit the interconnectedness of the financial institutions and establishing greater regulatory oversight.

The Federal Reserve System, which was founded by Congress in 1913, is the central bank of the United States. Its purpose is to provide the U.S. with a safe, flexible, and stable monetary and financial system. Over the years, its role in banking and the economy has expanded. The duties of the Federal Reserve System include maintaining the stability of the financial system and containing systemic risk that may arise in financial markets (Board of Governors of the Federal Reserve System, 2005) .

The Securities and Exchange Commission (SEC) was founded in 1933 to renew investor confidence in the capital markets by providing investors and markets with a regulatory framework that established clear rules of honest dealing as well as an information and reporting system that would be reliable. The impetus for the formation of the SEC was the restoration of confidence in the U.S. capital markets after the Great Crash of 1929. Congress undertook efforts to restore confidence in the financial

markets by enacting the Securities Act of 1933, which was followed by the Securities Exchange Act of 1934, creating the SEC (Securities and Exchange Commission, 2009). One consequence of the stock market crash in October 1929 was that public confidence in the financial markets plummeted. Many individual and institutional investors lost substantial sums of money as a result of the bursting of the speculative bubble which preceded the Great Depression. In addition to wealth destruction, confidence in the trustworthiness of the financial system was undermined by revelations regarding questionable ethical behavior by leaders of top financial institutions. Charles E. Mitchell, head of National City Bank, predecessor to today's Citibank and one of the country's largest banks, was indicted and arrested (Galbraith, 1954). Congressional hearings further highlighted events and circumstances which raised serious questions regarding the trustworthiness and dealings of leaders of financial institutions (Galbraith, 1954). The SEC was established to restore confidence in a financial system that had been shaken.

Additional post-Depression era legislation which guided the development of the financial system included the Banking Act of 1933 and the Glass-Steagall Act which, in an effort to restore confidence in commercial banking institutions, mandated the separation of commercial bank and investment bank activities. Isolating more speculative, risk-taking businesses, such as purchasing and holding speculative securities and underwriting new issues, into the realm of investment banks was designed to protect the financial system by limiting excessive risk-taking at the commercial banks, whose main functions were to promote and protect savings and to enable lending.

The newly designed financial system was developed to foster stability and growth, such that cataclysmic financial crises would be avoided in the future. The system emphasized policy initiatives and governance structures which focused on greater disclosure and information reporting by and for market participants, and greater regulatory oversight (Galbraith, 1954). Certainly there are many other critical components of the U.S. financial system. The point of emphasis is that the post-Depression financial system was designed by regulators and policy makers to restore public trust and support economic growth while preventing financial system collapse.

The post-depression policy and regulatory changes were effective in restoring public trust in the financial system. They served the financial system and the nation well for over half a century, enabling an unprecedented period of prolonged growth and prosperity. Nevertheless, during the financial meltdown of 2008, it became apparent that a new set of challenges existed as the financial system was once again exposed as highly vulnerable to collapse.

3.2.2 The Financial Crisis of 2008

In September 2008, the U.S. Government did not intervene as Lehman Brothers became insolvent, declared bankruptcy, and commenced liquidation. However, in the immediate aftermath of the Lehman bankruptcy, near panic swept throughout the financial system (Fender & Gyntelberg, 2008). While Lehman was allowed to fail, the apparently unanticipated staggering repercussions throughout the financial system forced a recognition by financial system regulators and the U.S. policymakers that the

failure of a second large financial institution—whether a commercial bank, investment bank, or insurance company—could have a devastating effect on the entire financial system (Mollenkamp, Whitehouse, Hilsenrath, & Dugan, 2008). The systemic risks related to the possible failure of any one of these institutions was too a great a risk for the government to take (Paulson, 2010).

This circumstance, where the failure of a larger financial institution threatens the viability of the entire financial system, results in the common reference to these institutions as “too big” and “too interconnected” to fail—“too big” in the sense of the sheer concentration of economic risk which the institutions have accumulated and “too interconnected” in that the failure of the institution will have a destructive ripple, domino, or contagion effect on other financial institutions and the entire financial system.

The anxieties regarding the ripple effects of the Lehman failure were based upon a variety of factors, including the fact that many institutions owned substantial amounts of Lehman debt and also that Lehman was the custodian of the financial assets of several financial institutions. Lehman was an important and large participant in an interconnected financial system and Lehman’s complete failure triggered substantial economic loss and grave concern regarding additional losses that would cascade throughout the entire system (Mollenkamp, Craig, Ng, & Lucchetti, 2008).

A crucial development during this period was the unprecedented action taken by the U.S. Government to avoid the complete collapse of a second major U.S. financial institution (Dash, Sorkin, Merced, & Herszenhorn, 2008). The U.S. government put in place a series of safety nets designed to avert the collapse of institutions which are

thought of as too big or too interconnected to fail. The form of the government's intervention varied and included a wide arsenal of tools to prevent firms from failing. A key tool used by the government was the addition of capital to these institutions through the purchase of preferred stock with the simultaneous addition of liquidity to the financial system through multiple methods (Federal Reserve Bank, 2008). Estimates of the aggregate cost of the various government programs vary. The Troubled Asset Relief Program (TARP), the program specifically designed to bailout the banks and automobile companies, is estimated to have had an initial cost of \$700 billion. In addition, the total amount of government commitments to rescue the financial system through an array of other programs has at times been estimated to exceed \$10 trillion (The New York Times, 2009). In sum, the fear of systemic financial collapse created a government response of gargantuan scale financed wholly through public funds ultimately borne by taxpayers.

3.2.3 Too Big To Fail—Too Interconnected to Fail: The Longstreth Thesis

If market discipline is to operate efficiently, financial intermediaries must be permitted to fail. But the growing interdependence among financial institutions and their resulting vulnerability, as noted earlier, makes a failure—at least among the larger firms—an unacceptable result. For many of our larger financial firms, the collateral repercussions of failure would be intolerable. In many cases, the costs of resuscitating a failing firm would be far less than the system-wide costs of letting it go. (Longstreth, 1983)

While the government intervention stabilized the financial system, one notable consequence of such intervention was a vivid reminder that systemic financial system vulnerabilities emerge as individual financial institutions become so enormous and entrenched in economic activity that the consequence of their failure would be catastrophic for economic and social system. With a focus primarily on investment banks, key developments will be analyzed that enabled financial institutions to grow to the point where their potential failure created a crisis of confidence in the entire financial system.

In February 1983, SEC Commissioner Bevis Longstreth, in remarks to the New York Regional Group of the American Society of Corporate Secretaries addressed the emerging systemic risks that he was concerned with as a result of the ever-increasing size of the role that the largest and most vital financial institutions played in the overall economic system (Longstreth, 1983). In an analysis that was eerily prescient of the current financial crisis, Longstreth advanced the thesis that:

- Market discipline can only assure soundness in an environment where institutions are permitted to fail;
- The linkages among financial intermediaries often are too extensive (and growing stronger and more numerous) to prevent one failure from triggering others;
- Therefore, the collateral consequences of failures often pose unacceptable costs to our financial system.

Longstreth, who envisioned a financial system with direct regulation of institutions so strong that the market forces of full disclosure would protect the market, went on to warn presciently about the moral hazards of government bailouts:

The expectation that government would have to intervene prevents the market place from operating efficiently. The realization among large bank depositors and creditors that they would not be required to absorb the full consequences of a bank failure erodes the incentive necessary to conduct their money management activities in a manner designed to deter the bank from incurring excessive risk. Unrestrained, the firm would be free to adopt a risk preference greater than with soundness. This analysis suggests the necessity, as a matter of public policy, of continuing to rely on direct regulation to prevent financial intermediaries from becoming tempted to incur unacceptable risks.

Given the overall regulatory and governance framework and the knowledge and ideas of Longstreth and others which date to over 25 years ago, a number of questions arise: How did the financial system allow so many institutions to grow to the point where their failure threatened the overall system? How did such substantial concentrations of economic risk evolve such that a number of too-big-to-fail institutions became up so vulnerable?

3.2.4 Wall Street Firms Convert from Private Partnerships to Public Corporations

The New York Stock Exchange traces its roots back to 1792 when what is known as the Buttonwood Agreement was signed by 24 merchants and brokers (NYSE, 2009). In 1970 the NYSE changed its rules and regulations and allowed member firms to go public. From the time of the Buttonwood Agreement until 1970, firms that were members of the NYSE were not allowed to be publicly owned, and consequently most member firms were organized as partnerships. While limiting in certain respects, the nature of partnerships allowed for an alignment of interest among partners, who were both the capital providers, risk-takers, and operators of these firms. The constraints which the partnership structure placed on access to capital provided meaningful assurance that, as partnerships, these firms would likely never grow to the point where their potential failure would create a systemic financial crisis.

Driven primarily by a need for ever-increasing amounts of permanent capital as well as the advantage of limited personal liability, beginning in 1970 and continuing for the next three decades, most major U.S. investment banks transformed the organizational form of their business from a partnership to a public company form. Increasing permanent capital accounts by selling ownership stakes in the firm to the public substantially increased the amount of permanent capital that investment banks had. Additionally, the corporate ownership structure shielded executives from personal risk. The permanent capital accounts of investment banks provided increased financial strength and confidence to the firm's customers, counterparties, and the overall marketplace.

The process of going public began when the investment firm of Donaldson, Lufkin, and Jenrette went public in 1970 and continued through May 1999 when

Goldman Sachs made the some transition. An example of the stated rationale for such public offering is the use of proceeds description included in the Merrill Lynch, Pierce, Fenner and Smith common stock offering on June 23, 1971:

The firm's management considers an addition to its permanent capital to be desirable at this time in view of the increase in the firm's business as a broker, dealer and underwriter and its long range plans for continued expansion. Construction and equipping of a new home office building will necessitate substantial capital expenditure. In deciding to increase the firm's capital at this time, management also took into account the proposed changes in NYSE rules imposing more stringent net capital requirements ...

With access to greater amounts of capital the investment banking business model entered a period of substantial change.

Among the important complexities that public ownership brought to the now publically owned investment banks was an operating reality that management and ownership were now different. One important aspect of the public model, particularly from the perspective of a former partner, was that now other people's money was involved in the business. Importantly, the limited liability corporate ownership form also immunized executives from personal liability.

While not sufficient to create the too-big-to-fail scale, the public format was a necessary precondition for and enabler of the investment banks to achieve the next level

of size, scale, and risk concentration. Unbridled by the transformational step of public ownership, the absence of the personal liability of partners, and access to ever-increasing capital pools, combined with a thirst for ever-increasing profits and compensation, investment banks began a period of prolonged growth and metamorphosis. The ensuing decades witnessed gradual, but momentous, shifts in the investment banking business model. From a post-depression business model primarily focused on earning commissions by executing customer brokerage transactions and underwriting new issues of securities, the business model shifted steadily to expanded proprietary risk-taking and structuring complex financial instruments. Both of these lines of business involved greater business risks and profitability.

The growth and importance of the investment banks is reflected in the total employment by the five largest banks which grew fourfold from 1979 to 2000. More significantly, the growth in employees was dwarfed by the growth in capital per employee from a range of \$27,000 to \$113,000 in 1979 to a range of \$875,000 to \$3,585,000 in 2000 (Morrison & Wilhelm, 2007).

Increases in human capital and financial capital, combined with technological advances and advances in the sophistication of financial engineering, and broad-based economic growth enabled investment banks and other financial institutions to increase profits at a staggering pace. By 2006 the aggregate financial sector, including investment banks, commercial banks and insurance companies, accounted for 30% of U.S. corporate profits up from 10% in 1986 (Blankenburg & Palma, 2009). In part these profits reflect a growth in global financial assets from \$12 trillion in 1980 to just under \$200 trillion in 2007 (Blankenburg & Palma, 2009). Other measures of the

growth and centrality of the investment banks included revenue and profit growth, growth in executive compensations, growth in underwritings, and growth in client financial assets held. With far greater capital, technology, and innovation, these institutions became massive risk-takers with enormous on-balance sheet and off-balance sheet economic interests.

Similar influences were also impacting other financial institutions including commercial banks and insurance companies. A particularly noteworthy legislative development related to the risk profile, size and interconnectivity of financial institutions occurred in 1999 when the Glass-Steagall act was repealed and, among other provisions, no longer prohibited commercial banks from being engaged in the investment banking or insurance businesses. The repeal of Glass-Steagall altered the risk dynamics of commercial banks and the entire financial system and opened the door in a new era of bigger more interconnected financial supermarkets.

3.2.5 Securitization, Credit Default Swaps, and the Relaxation of Capital Requirements

The expanded size and risk profile of the major financial institutions set the stage for the subsequent series of developments which further jettisoned the leading financial institutions to such a size and interconnectedness that their failure became a real threat to the entire financial system. Importantly, several regulatory developments during the past two decades fostered a further increase in the risk profile and interconnectivity of the investment banks and other financial institutions. While it is beyond the scope to discuss these matters in depth, three of these developments—

securitization, the credit default swaps, and relaxation of capital requirements--are important to emphasize here.

The past decade has seen enormous development and extensions of new forms of securitization and the growing use of derivatives of all kinds which contributed to additional further growth, risk, and interconnectivity in the financial system (Goodhart, 2008). Perhaps no transaction has become as infamous as the credit default swap which can be used to exchange credit risks among counterparties. The Commodity Futures Modernization Act of 2000, the enabling federal legislation, opened the floodgates for the proliferation of over-the-counter swap transactions including credit default swaps (106th Congress Second Session, 2000). An important impetus behind this legislation was a joint presidential commission that included Wall Street professionals as well as Washington regulators. The net result was a green light for the significant expansion of unregulated derivative structures and transactions. These instruments exploded in growth during the 2000s.

One of these structures, the credit default swap, grew at a staggering rate. By 2008, estimates of the outstanding amount of credit default swaps (CDS) approximated US\$60 trillion on a gross level and \$14 trillion after netting off-setting contracts (Tett, 2009). One natural consequence of these structures was an increase in the systemic interconnectivity of the counterparties to these transactions: sellers and buyers of credit risk.

AIG was a major participant in the market for credit default swaps. Systemic interconnectivity increased as counterparties to AIG credit default swaps relied upon AIG's ability to pay them should events occur which necessitated such payments. The

size and scale and interconnectedness of AIG's activities created a circumstance where in September 2008 the government intervened as fears grew that the contagion implications of AIG's failure would be catastrophic (Tett, 2009). Governance of the financial system, aimed at avoiding systemically dangerous risk levels, had failed. AIG was too big and too interconnected to fail.

A final ingredient that has been implicated in the transformation of investment banks to institutions that are too big to fail was the decision by the SEC in 2004 to allow the largest investment banks to increase their total borrowings relative to their capital (Labaton, 2008). Historically, this relationship, which is known as a firm's leverage ratio, averaged around 12 to one, meaning \$12 of borrowing for \$1 of capital. As a consequence of an SEC rule change the investment banks were allowed to expand to roughly \$33 to \$1 (Pickard, 2008).

As a result of this change an investment bank could now purchase and hold \$33 of financial assets for every \$1 of capital. The \$32 difference would be made up with borrowings. By extension, \$1 million of capital could now be used to purchase and hold \$33 million of financial assets, up from \$12 million prior to the rule change. A further extension would be that given capital of \$10 billion, the assets held, which would include some form of sub-prime mortgage exposure, could grow to \$330 billion. Big, became much bigger as a result of this ruling.

3.2.6 Too Big and Too Interconnected to Fail

The cumulative effect of the various developments described above—public structure, limited liability, large capital pools, technology, regulatory accommodation,

and a growing economy—all interacted to fuel an era of prosperity. These changes interacted with other factors, including executive compensation plans which arguably incentivized risk-taking (Palmon, Santoro, & Strauss, 2009), and the outcome was the transformation of a number of financial firms into extremely large, highly leveraged, risk-taking financial institutions of enormous size.

Institutions that were large to begin with now took on an entirely new position in the financial system. They evolved to systemically interconnected, mutually dependent, risk-taking behemoths, several of which—including AIG, Bank of America, and Citibank—were too big and too interconnected to fail and consequently required government bailouts to survive.

The analysis presented argues that beyond a breakdown in economic circumstances, it is important to understand the financial crisis which began in 2008 from a historical perspective. The financial system, as has been painfully learned, does not simply include the institutions that became too big to fail, but also the regulators, policymakers, and supervisors who are charged by the public to protect the system.

3.3 Ethical Analysis

3.3.1 Introduction

The examination now shifts to analyzing the historical developments from an ethical perspective. Two specific ethical dimensions are the focus of the moral analysis: collective moral agency and institutional moral responsibility. The analysis is designed to assess whether a fuller understanding of these ethical dimensions can contribute to a

better understanding of factors which influenced the evolution of too-big-to-fail institutions.

Moral hazard is a familiar concept in the insurance industry, where it refers to a choice made by individuals to take more risks if they are insured against the repercussions of such risks. For example, leaving the front door open, when one has insurance against burglaries or similarly, purchasing health insurance if one smokes. Substantial ethical complexities arise when the risks one takes advance beyond the realm of impacting the individual who is taking on the additional risk; for example, when someone smokes in bed knowing that he or she has fire insurance, the moral hazard implications of that choice have wider ramifications due to the potential contagion effect of a fire. When the consequences of the risks taken by an individual go beyond impacting the individual, irresponsible decisions and actions could adversely impact a far broader community.

When the economic risks taken by a single financial institution go beyond threatening the viability of such institution and such risks have the potential to trigger a contagion sequence, the moral hazard is no longer a matter of private property, but one of significant public concern. Longstreth was explicit in warning that the size of financial institutions should be restrained such that their failure would not threaten the failure of the entire financial system. His statement that “unrestrained, the firm would be free to adopt a risk preference greater than with soundness” acknowledges moral hazard as a consideration regarding financial system governance. The governance mechanisms which he identifies as crucial for the protection of the financial system include the ability of institutions to truly fail and the need for regulators to be vigilant.

3.3.2 Collective Moral Agency

Initially, the question examined is whether a conglomeration of people in various regulatory and policymaking functions responsible for the safety and soundness of the financial system have collective moral agency responsibility and, if so, what the implications of such moral responsibility may involve. Secondly, questions of institutional moral responsibility are examined to analyze whether such responsibilities may in fact exist and, if so, whether a more complete understanding of institutional moral hazard may contribute to a fuller understating of the systemic risks which led to the collapse of the financial system.

E. Gerald Corrigan, former head of the New York Federal Reserve Bank of Minneapolis and New York, addressed why banks are special and require government regulation and protection when, in 1982, he argued that the public interest considerations associated with banking call for banks to have access to the full-scale public safety net for financial institutions (Corrigan, 1982). Implicit in such comments is the belief that government policies, regulation, and supervision would be effective, collectively, at protecting the public interest. The question is whether there is a moral dimension to this collective responsibility.

If such collective responsibility can be established, a question to be raised is whether a breakdown of such collective agency was a factor that contributed to the unchecked and explosive growth of financial institutions that evolved to becoming too big to fail. Further, can such failure of collective agency constitute a moral failure which can be attributed to the collective of regulators? Finally, the implication of such

collective moral responsibilities on the design of future systemic governance is considered.

The philosophical complexities of collective moral agency have been and continue to be examined. Questions that have been examined relate to understanding if groups, separately from individual members of the group, can have moral responsibilities (May, 1987). In addition to developing arguments which extend moral responsibilities to groups, other research has focused on precisely what constitutes a group and whether individuals need to know that they are part of a group which shares a collective moral responsibility (McGary, 1986).

Corlett examined the complexities of the conditions necessary for determining whether collective moral responsibility exists among a conglomerate of people. One of several factors which he examined is the explicit condition that the causally contributory conduct by a collective group was in some way faulty (i.e. creates harmful outcome) (Corlett, 2001). Corlett clarified by stating, “As with individuals, we want to know whether or not collectives may be morally liable for their inactions (omissions) as well as for their actions as they are causes (of one kind or another) of outcomes or states of affairs” (Corlett, 2001).

While analysis of collective moral responsibility can involve corporate morality or moral obligations of social groups, the analysis here examines whether a group of regulators, policymakers, and supervisors can constitute a collective with collective moral responsibility. The hypothesis examined is that the individuals who are involved in the governance of the system do have collective responsibilities which are connected by a common responsibility of protecting the interest of society. Further, such

responsibility includes a moral dimension to protect the public interest. Central to this morality is the process of ensuring the safety and soundness of the financial system. Such morality includes responsibilities to do no harm to the system, and in this regard, ensure that no single member or participant acts or grows to the point where they can cause harm to others, particularly when the risks such participants take are motivated by their own private benefit (Robin, 2009). Regulating and monitoring the activities of financial system participants, through regulatory oversight, are vital governance activities which attempt to monitor excessive risk-taking by an institution (Longstreth, 1983). Yet, Corlett stated that:

But even if collective intentionality and voluntariness obtained in a given circumstance, collective moral responsibility would not accrue unless some significant measure of collective knowledge also obtained therein. To the extent that acting knowingly is a condition the satisfaction of which is crucial for moral liability, it is unjustified, normally, to attribute moral liability to such collectives. I say “normally” because there are cases in which a moral agent’s ignorance does not exculpate. (2001)

Was the consequence of the cumulative impact of regulatory and policy decisions, discussed earlier, the result of ignorance, or a more conscious, morally problematic set of actions and decisions that eroded the moral aspects of the Longstreth thesis? Can ignorance be excused in this case when significant public debate regarding the risks on too-big-to-fail institutions was taking place? Important further work

remains to be done with respect to these core questions. And yet, from the perspective of society and the overall economic system, a financial system design which explicitly embraces the collective moral responsibility of regulators, policymakers, and supervisors would arguably further strengthen the vigilance with which limiting the size of financial institutions is approached.

Francis and Armstrong (2003) argued that good ethical practice is essential for good risk management (Francis and Armstrong, 2003). In the case of the financial system, the question is what is good risk management and good ethical practice. Given the events of the financial crisis it would seem clear that good ethical practice in the design of the financial system includes considering a collective moral responsibility of limiting concentrations of economic risk, as well as having a firm understanding of the underlying moral imperative that protect the safety of the system.

Limiting profit, compensation, and growth opportunities of major financial institutions by limiting the size and interconnectedness of institutions may be the moral imperative necessary to fully protect the system from the self-interested actions and decisions of all participants.

3.3.3 Institutional Moral Hazard

While individual moral responsibility and the concept of moral hazard are generally accepted and understood aspects of moral philosophy and ethics, extending these concepts beyond individuals to institutions is the subject of ongoing analysis. Soares (2003) develops the theory that the complexity of modern economic activity is such that institutions need to recognize their moral responsibilities which take into

consideration the interests of society. Beyond the well accepted theories of individual moral behavior, Soares argues that corporations have collective or corporate social responsibility (Soares, 2003). This argument is consistent with Iyer's observation that society needs to be more aware of the nature of corporate-social interaction such that corporate social responsibility can be dealt with more comprehensively (Iyer, 2006).

Beyond the philosophical or conceptual aspect of corporate morality, it is the link between the operating practices of corporations, including financial institutions, and their corporate morality that provides the means for converting moral hazard into real economic risks for the financial system. The operating means exist in corporations to implement decisions. French (1996) posited that it is precisely the corporate organization structure which enables implementation of decisions (French, 1996). From this perspective, what insights are available as to how moral hazard risk may have impacted the operation activities of financial institutions?

The junction of institutional morality and operating practice may be best revealed through the system of compensation incentives that is established to incentive employee decisions and behavior. An important element motivating the behavior of financial institution executives is the system of incentive compensation which is in place at many financial institutions.

Self-interested executives of these financial institutions may pursue excessive risk, knowing that they would benefit on the upside and that the government intervention would protect the institution from insolvency on the downside if the institution was sufficiently large and interconnected to be systemically vital to the entire system. In such circumstance, the cost/benefit calculus of an institution and its self-

interested executives could result in excessive risk-taking. The benefits of excessive risk accrue to the financial institution while the costs, most notably catastrophic losses, would be backstopped by the government and ultimately taxpayers. Noteworthy here are the substantial amounts of cash-based executive incentive compensation which may have exacerbated the risk taking appetite at major institutions that failed (Palmon et al., 2009).

Compensation systems are one example of the means in which institutional moral hazard may increase the business risk at an institution. When Longstreth argues for strong regulatory oversight to compensate for the moral hazards at the firms, he is burdening the disparate regulators with the responsibility to protect the system from potential reckless, self-interested risk-taking by self-interest market participants.

In a similar vein, former Federal Reserve Bank Chairman Paul A. Volcker recently stated while referring to the government's recent actions: "The danger is the spread of moral hazard could make the next crisis much bigger" (Dorning, 2009).

3.4 Crisis Intervention

The moral hazard analysis developed here needs to be distinguished from the debate regarding whether intervention during an actual financial crisis is in fact a proper solution or whether it simply exacerbates moral hazard (Summers, 2008). Summers (2008) argued against moral hazard fundamentalism in the face of a financial crisis. Saving the overall financial system during crisis is of paramount importance to society, he suggested, and the ongoing moral hazard at large financial institutions is a cost necessary to prevent the collapse of the financial system and risk collapse of the

economy other social structures (Summers, 2008). This debate is not the focus of the analysis here. Rather, the analysis focuses on the ethical sensibilities of a financial system design which allows, or even encourages, individual financial institutions to grow to the point where their size, scope or risk profile could threaten the entire system.

3.5 Conclusion

Beyond a breakdown in economic circumstances, it is important to understand the financial crisis which began in 2008 from a historical perspective and an ethical perspective. As policymakers and regulators around the globe make vitally important decisions regarding the governance of the financial systems, understanding of historical and ethical aspects of the U.S. financial crisis will be an important element which frames a new regulatory and policy era. Systemic risks must be contained in light of the vulnerabilities which moral hazard and absence of clear collective moral agency have exposed. Simply stated, in light of individual and collective moral hazards the overall governance framework which protects the financial system should explicitly adopt as a moral imperative a standard such that any financial institution could fail without such failure threatening the entire financial system. Failure risk will counterbalance the moral hazards.

Clearly there still are major, systemically important financial institutions that exist. It is in these cases that risk reduction efforts would be consistent with the arguments here. Smaller institutions, less interconnected institutions, need to be

embraced as solutions to roll back the existing moral hazards which continue to threaten the financial system.

Many questions remain, and the examination of the ethical dimension of too-big-to-fail needs to be furthered. Questions to be considered include: 1) Beyond limiting the size and interconnectivity of institutions through regulation, disclosure and governance, is there an ethical perspective to constrain firms such that they operate in a fashion in which are fully accountable and responsible for the consequences of their decisions? 2) Can ethics bring an altered perspective to the board rooms and executive suites of financial institutions? 3) Do the systemic implications of excessive risk alter society's ethical perspective on individual institution profit-making?

References

- 106th Congress Second Session. (2000). *Commodity Futures Modernization Act of 2000*.
- Blankenburg, S., & Palma, J. G. (2009). Introduction: The global financial crisis. *Cambridge Journal of Economics*, 33(4), 531-538.
- Board of Governors of the Federal Reserve System. (2005). *The Federal Reserve System purposes and functions*. Washington: Federal Reserve Bank.
- Corlett, J. A. (2001). Collective moral responsibility. *Journal of Social Philosophy*, 32(4), 573-584.
- Corrigan, E. G. (1982). Are Banks Special? *1982 Annual Report*, The Federal Reserve Bank of Minneapolis.
- Dash, E., Sorkin, A. R., Merced, M. J. D. L., & Herszenhorn, D. M. (2008, September 18). Throwing a lifeline to a troubled giant. *The New York Times*.
- Dorning, M. (2009, September 24). Volcker criticizes Obama plan on "systemically important" firms. Bloomberg News.
- Federal Reserve Bank. (2008). *Trouble Asset Relief Program (TARP)*. Retrieved October 18, 2008, from <http://www.federalreserve.gov/bankinfo/tarpinfo.html>.
- Fender, I., & Gyntelberg, J. (2008, December). Overview: global financial crisis spurs unprecedented policy actions. *BIS Quarterly Review*, 1-24.

- Francis, R., & Armstrong, A. (2003). Ethics as a risk management strategy: The Australian experience. *Journal of Business Ethics*, 45(4), 375-385.
- French, P. (1996). Corporate moral agency. In P. Werhane & E. P. Freeman (Eds.), *Blackwell encyclopedic dictionary of business ethics* (Vol. XI, pp. 148-151). London: Blackwell.
- Galbraith, J. K. (1954). *The great crash of 1929*. New York: Houghton Mifflin.
- Goodhart, C. (2008). The background to the 2007 financial crisis. *International Economics and Economic Policy*, 4(4), 331-346.
- Iyer, A. A. (2006). The missing dynamic: Corporations, individuals and contracts. *Journal of Business Ethics*, 67(4), 393-406.
- Labaton, S. (2008, October 3). Agency's '04 rule let banks pile up now debt. *The New York Times*.
- Longstreth, B. (1983). In search of a new safety net for the financial services industry. *Securities and Exchange Commission*, <http://www.sec.gov/news/speech/1983/021083longstreth.pdf>.
- May, L. (1987). *The morality of groups*. University of Notre Dame Press. Notre Dame, Indiana.
- McGary, H. (1986). Morality and collective liability. *Journal of Value Inquiry*(20), 157-165.
- Mollenkamp, C., Craig, S., Ng, S., & Lucchetti, A. (2008). Lehman files for bankruptcy, Merrill sold, AIG seeks cash. *The Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB122145492097035549.html?mod=relevancy>.

- Mollenkamp, C., Whitehouse, M., Hilsenrath, J., & Dugan, I. J. (2008). Lehman's demise triggered cash crunch around globe. *The Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB122266132599384845.html?mod=relevancy>.
- Morrison, A. D., & Wilhelm, W. J., Jr. (2007). *Investment banking: Institutions, politics, law*. New York: Oxford University Press.
- NYSE, E. (2009). *History - Overview*. Retrieved from <http://www.nyse.com/about/history/1089312755484.html>.
- Palmon, D., Santoro, M., & Strauss, R. (2009). Pay now lose later: The role of bonuses and non-equity incentives in the financial crisis of 2007-2008. *The Open Ethics Journal*, 3.
- Paulson, H., Jr. (2010). *On the brink*. Hachette Book Group, New York.
- Pickard, L. A. (2008, August 8). SEC's old capital approach was tried and true. *American Banker*.
- Robin, D. (2009). Toward an applied meaning for ethics in business. *Journal of Business Ethics*, 89(1), 139-150.
- Securities and Exchange Commission, U. S. (2009). *Laws that govern the industry*. Retrieved from <http://www.sec.gov/about/whatwedo.shtml>.
- Soares, C. (2003). Corporate versus individual moral responsibility. *Journal of Business Ethics*, 46(2), 143-150.
- Summers, L. (2008). Beware moral hazard fundamentalists. *Financial Times*. Retrieved from <http://www.ft.com/cms/s/0/5ffd2606-69e8-11dc-a571-0000779fd2ac.html>.

Tett, G. (2009). *Fool's gold: How unrestrained greed corrupted a dream, shattered global markets and unleashed a catastrophe*. London: Little, Brown.

The New York Times. (2009, February 4). Adding up the government's total bailout tab. *The New York Times*. Retrieved from <http://www.nytimes.com/interactive/2009/02/04/business/20090205-bailout-totals-graphic.html>.

Chapter 4: The Ethical Content of Accounting Information

Abstract

This paper sets forth a theory that accounting information can provide insights into the ethics of an organization. While the primary purpose of accounting information is to provide information on the economic activity of a firm, it is argued that the informational content of accounting measurements and disclosures includes ethical information regarding a corporation. A theoretical framework is developed for decoding accounting information such that ethical information regarding a firm can be revealed. From the perspective of the overall economic system, ethical information from company financial reports may provide insights regarding overall economic system risk. The theory developed in this paper extends the information content of accounting information to non-financial information.

Keywords: accounting ethics, ethical disclosures

The Ethical Content of Accounting Information

4.1 Introduction

The primary purpose of accounting information is to communicate financial and economic information about a corporation to users of financial statements. This paper develops the theory that, in addition to financial information, ethical content is imbedded in accounting information and such content may prove useful in an analysis of the ethics of a corporation. At an economic system level, decoding the ethical content of accounting disclosures may, in the aggregate, contribute to an assessment of overall economic system risk. While academic research has focused intermittently on the ethics of accounting information, a generally accepted theory on the ethical content of accounting information has not been established.

Scholarly efforts which explicitly examine the intersection of accounting and ethics generally focus on the behaviors and morality of professional accountants and auditors (Cheffers & Pakaluk, 2007; Duska & Duska, 2003; McPhail & Walters, 2009). The analysis in this paper focuses not on professional accountants or auditors but on accounting information itself and establishes a framework and preliminary methodologies for applying ethical analysis to accounting information disclosed by corporations. This paper extends the information content of accounting information to non-financial information.

As discussed in the literature review, the analysis developed in this paper is consistent with academic research which argues that corporations are moral agents and,

as such, have moral responsibilities and a moral dimension. As moral agents, public corporations have the operating skill and hierarchical structure to operate consistent with their morality (French, 1979). Consequently, decisions or actions taken by such moral agents, particularly those which involve consideration of both the private interests of firms and the public interests of shareholders and extended stakeholder groups, may be influenced by the agents' morality. The question examined in this paper is whether an analysis of choices made by such moral agents, when selecting from a set of acceptable accounting measurement and disclosure options, can provide insight into the moral character of such organization. An alternative framing of this question is whether the selection of an accounting information alternative, whether a measurement choice or disclosure choice, can provide a window into the ethics of a company: is there ethical content to accounting information?

In this paper the thesis is developed that there is ethical content in accounting information and that the selection of accounting information or financial reporting disclosure alternatives can provide information regarding the ethics of a corporation. Further, the outcome of such decisions is generally available in publically disclosed accounting information and financial disclosures and therefore available for examination and analysis. Analysis of such publically available output from accounting information systems is argued to be a useful source of insight into the ethics of a corporation.

Finally, the argument is set forth that ethical insights into firms can also be revealed by examining how a firm employs output from its accounting information

systems. In this regard, as noted in Essay 1, the relationship between executive compensation and accounting information is most important.

4.2 Literature Review

The literature review incorporates streams of research from both the accounting and business ethics disciplines. The intersection of these research streams is the conceptual genesis for the theory developed in this paper.

4.2.1 Financial Statement Fraud

While the vast majority of public companies in the United States and globally are not involved in accounting frauds, accounting scandals undermine investor confidence and heighten concerns regarding the ethics of corporations. In its most recent report on corporate fraud issued in May, 2010, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) reported on financial fraud in the United States during the period from 1998 - 2007 (Committee of Sponsoring Organizations of the Treadway Commission, 2010). The report identified in excess of 345 cases of public company fraudulent financial reporting from 1998 to 2007 with a total cumulative misstatement or misappropriation of nearly \$120 billion (mean of nearly \$400 million per case). Fraudulent financial reporting as defined by COSO is the intentional material misstatement of financial statements or financial disclosures in notes to the financial statements or Securities and Exchange Commission (SEC) filings or the perpetration of an illegal act that has a material direct effect on the financial statements or financial disclosures. The notable cases in the report include Enron,

Xerox, WorldCom and HealthSouth. In addition to financial fraud in the United States, high-profile international cases such as Parmalat and Royal Ahold have provided evidence of financial fraud on a global scale (Brooks & Dunn, 2010).

The 2010 COSO report was not the first red flag to be raised with respect to the failures of corporate accounting. An earlier COSO report, issued in 1997, detailed financial reporting frauds from an earlier era. While fraudulent financial reporting, once detected, raises clear issues with respect to the ethics of corporations, non-fraudulent financial reporting may also provide clues as to a corporation's ethics.

4.2.2 Financial Crisis Implications

Non-fraudulent output of accounting information systems may also provide information regarding the ethics of a public company as public corporations can avail themselves of a range of alternatives with respect to the measurement and disclosure of accounting information. For example, specifically with respect to the financial crisis which began in 2008, while fraud has not been charged, there have been arguments made that accounting information, particularly accounting valuations of mortgage-backed securities, raises ethical issues and may have contributed to the crisis. Valuing securities with limited or no market is certainly an economic issue; however, to the extent that such accruals comprise substantial components of net earnings there are questions being raised regarding the ethical dimensions of such practices (Palmon, Santoro, & Strauss, 2009). Additionally, the 2010 SEC settlement with Goldman Sachs, related to the ABACUS structure, implies that non-fraudulent financial disclosures are an important signal regarding the ethics of business and markets

(Securities and Exchange Commission, 2010). Furthermore, questions have been raised regarding the ethics of an accounting practice followed by Lehman Brothers, Citibank, and Bank of America of recording certain security repurchase transactions (repos) as sales rather than borrowings (Rapoport, 2010). In these and other cases the accounting information and disclosure choices made by corporations are reflected in the publically available financial reports which publically owned companies are required under the SEC and New York Stock Exchange rule to prepare, disclose, and disseminate.

4.2.3 Accounting and Society

Questions have been raised as to whether accounting, as an information system, has relinquished any moral perspective as a result of accommodating the informational needs of capitalism. Tinker has written that

the absence of any social perspective in accounting disqualifies it from having anything authoritative to say about the public character of corporations; worse, by systematically excluding all social content from its theoretical agenda, and by persistently disenfranchising certain groups and social constituencies, accounting stands accused of partisanship and bias. (1985)

Tinker argued for emancipatory accounting which includes, among other characteristics, accounting information systems capable of recognizing the alienating effects of capitalism related to the value of labor. He warns of the social implications of market exchanges based upon accounting valuations (accounting information) which creates or potentially creates socially unjust circumstances. He argues that accounting

principles should avoid being complicit in such a potentially socially unfair situation (Tinker, 1985).

An exposition of capitalism versus other economic and social systems is not the focus here. Rather, the focus of the analysis in this paper is on probing and extracting additional information, ethical information, from accounting information as currently disclosed by U.S corporations. While the roots of this paper are planted in the current capitalistic economic and social system, a link to the perspectives of Tinker and others is that accounting information systems incorporate social and economic circumstances and have an ethical dimension. Reinforcing this perspective, Corbin stated:

The social importance of accounting should be mentioned in this context. Accounting is a means of communication in a complex financially-dominated society. It provides information for making many decisions, not only by management, but by almost all important groups in society. Therefore, accounting principles are of concern to almost everyone.... Seeing that realistic information is fully disclosed by independent, socially responsible accountants is requisite for business management and also for society. (1962)

4.2.4 Accounting Information

Accounting includes those activities that identify, record, and communicate information about an organization's economic activities (American Accounting Association, 1966; Weygandt, Kimmel, & Kieso, 2008). The accounting information system, as the term is applied throughout this paper, is the integrated set of accounting

activities, including financial reporting and disclosures, that may or may not be enhanced by computerization or other technologies. The use of the term *accounting information systems* in this paper fully incorporates the underlying principles, procedures, and rules that form the accounting information system whether automated or not.

The principal objective of an accounting information system is to provide information to users of the information about the economic activity of an organization (American Accounting Association, 1966). In the United States, the foundational principles which form the guiding framework for the capture, recording, and disclosure of accounting information is known as Generally Accepted Accounting Principles (GAAP). While these principles were not formally developed as an application of moral theory, the ethical aspects of these principles were also not ignored (Hendriksen, 1977). The 1966 American Accounting Association publication “*A Statement of Basic Accounting Theory*” includes several discussions related to the ethical aspects of accounting information. While the ethical dimension of accounting information was not the focus of this foundational piece, the ethical dimension of accounting information was not omitted or ignored. For example, in a discussion of the future development of accounting theory, reference is made to “ethical aspects to this issue for the instinctive wants of individuals may not be the wants most needed by society” (American Accounting Association, 1966).

Within the accepted principles of accounting there are choices available to managers as to how to measure, account for, and disclose transactions (Weygandt et al.,

2008). There is no definitive, intrinsic, finite truth defined by accounting principles or theory; rather the outputs of accounting information systems are measurements and disclosure of economic activity that, within an acceptable range, are deemed as GAAP (Ronen & Yaari, 2008). The output of accounting information systems has variability with respect to ethics that nevertheless allows for such accounting to comply with GAAP.

The objective here is not to provide an overall ethical framework for accounting or accounting principles. Rather, the theory set forth in this paper is that an analysis of the choices which corporations makes with respect to GAAP compliant accounting information and financial reporting choices, is a repository of data for obtaining insight in the ethical dimension of a company.

To summarize, while accounting information is fundamentally a measure of economic activity, and ethical theory does not formally serve as the foundational theory for the principles for accounting, an ethical approach can be applied to understanding the vital aspects of accounting (Hendriksen, 1977).

4.2.5 Corporate Moral Agency

Whether corporations are, or can be, moral agents has been the subject of academic debate and analysis for considerable time. While individual moral responsibility and the concept of moral hazard are generally accepted and understood aspects of moral philosophy and ethics, extending these concepts beyond individuals to institutions is the subject of ongoing analysis. Donaldson begins his 1982 monograph,

Corporate Morality, by stating that “[m]orally speaking, corporations are unusual entities. A judge once bemoaned that ‘they have no pants to kick around or soul to damn’, and bemoaned that they ought to have both” (Donaldson, 1982).

While the literature examining corporate moral responsibility continues to evolve, substantial research has moved beyond the basic question of whether corporations have moral responsibility to a discussion of the nature of such moral dimension of a corporation (Wettstein, 2010). Soares (2003) argues that the complexity of modern economic activity is such that institutions need to recognize their moral responsibilities which take into consideration the interests of society (Soares, 2003). Beyond the well accepted theories of individual moral behavior, Soares argues that corporations have collective or corporate social responsibility. This argument is consistent with Iyer’s (2006) observation that society needs to be more aware of the nature of corporate-social interaction such that corporate social responsibility can be dealt with more comprehensively (Iyer, 2006).

Beyond the philosophical or conceptual aspect of corporate morality, it is the link between the operating practices of corporations, including financial institutions, and their corporate morality that provides the means for converting moral hazard into real economic risks for the financial system. The operating means exist in corporations to implement decisions. French (1979) posited that it is precisely the corporate organization’s structures which enable implementation of decisions and such decisions support structure provides and important basis for applying moral agency to corporations (French, 1979).

The very nature of accounting is organizational and a primary purpose of accounting information is to communicate economic information regarding organizations. Corporations are the principal economic actors in the modern economy. Financial reporting by corporations comprises one of the most important communications from such economic agents. As discussed below, there are formal accounting information system principles and rules that companies must comply with.

Extending from the broad corporate moral agent question the analysis now shifts to the choices such moral agents make when selecting from a set of acceptable accounting options. Accounting choices are argued to have an ethical dimension, and the selection of an accounting alternative is a decision which may have a moral implications.

4.2.6 Ethics and Accounting Information

Scholarly work which analyzes the nexus of accounting choice decisions made by a corporation and firm ethics is not new. Frecka (2007) examined lease structures which are designed to avoid capitalization from an ethical perspective. The question examined by Frecka is whether it is ethical for a company to design lease terms to conform to operating lease accounting, knowing full well that while an accounting rule has been complied with a principle of accounting has been violated (Frecka, 2007).. There are other works as well which examine the intersection of accounting information and ethics. Depree and Grant (1999) incorporated ethical decision-making models in a study designed to evaluate choice involved in accounting for security investments. The

decision model they use specifically refers to utilitarian, justice, and rights-based ethical theories (DePree & Grant, 1999). Huang, Louwers, Moffitt, & Zhang (2008) drew upon ethical analysis to posit that the selection of independent board members is a signal by firms regarding their choices to avoid abusive accounting techniques.

While accounting information systems are replete with choices, certain choices cross into the area of earnings management. Substantial research, both analytical and empirical, has been conducted in the field of earning management which has been defined loosely as using managerial discretion over accounting choices to generate accounting earnings (Ronen & Yaari, 2008). Revsine (1991) has set forth a theory that managers selectively and non-fraudulently misrepresented financial results:

The selective misrepresentation hypothesis argues that managers prefer reporting methods that provide latitude in income determination (e.g., requiring choices among mutually acceptable alternatives) rather than methods that tightly specify statement numbers under given economic conditions. By providing managers with control over when they can report externally driven events, loose reporting standards can be used by managers to increase compensation, and to bide perquisite consumption, incompetence, or laziness.

Further, Revsine (1991) emphasized the non-fraudulent nature of such accounting information misrepresentations and that the degree and frequency of misrepresentation must indeed be selective:

Some reasonably close correspondence between economic events and accounting messages must predominate in order to instill confidence in affected parties. Without this correspondence, accounting numbers are unlikely to play any major role in contracting (Holmstrom, 1979). Stated somewhat differently, the fact that existing financial reporting rules predominantly reflect underlying economics is *not* inconsistent with selective misrepresentation. If the misrepresentations were pervasive, accounting would be discredited and the opportunity to use the numbers to effect wealth transfers would be limited.

Schipper emphasized a purposeful intervention in the external financial reporting process, with the intention of obtaining private gain as a characteristic of earnings management. Studies examining earnings management in financial reports, including work by Healy (1985; with Wahlen, 1999), have emphasized judgments brought to bear in the financial reporting process that may mislead some stakeholders. Such judgments have been the focus of substantial empirically testing through the examination of discretionary accruals. This research suggests that managerial ethics may impact accruals and that the selective use of accruals to window-dress may mislead users of financial statements (Healy & Wahlen, 1999). It is important to acknowledge explicitly that while accruals, which go beyond cash measures, are central to the fundamental role of accounting information, earning management focuses, in part, on those accruals which may mislead users of a firm's accounting information and disclosures.

SEC Chairman Arthur Levitt, in a September 1998 speech delivered at the NYU Center for Law and Business, referred to earnings management practices as “A game that runs counter to the very principles behind our market's strength and success.” Levitt (1998) attributed earnings management to the motivation to meet Wall Street's earnings expectations. As a result, he further stated “that we are witnessing erosion in the quality of earnings, and therefore, the quality of financial reporting” (Levitt, 1998).

While earnings management research does not explicitly seek to draw conclusions with respect to the ethics of corporations, many earnings management studies do discuss or acknowledge the ethical dimension of earnings management (Ronen & Yaari, 2008).

Importantly, while earnings management is generally characterized as motivated by manager self-interest misrepresentation, it has been acknowledged that not all earnings management is bad. As Arya, Glover, and Sunder 2003, stated:

Accounting research shows that income manipulation is not an unmitigated evil; within limits, it promotes efficient decisions. Our argument, admittedly controversial, is worth airing: earnings management and managerial discretion are intricately linked to serve multiple functions; accounting reform that ignores these interconnections could do more harm than good.

There are a multitude of earnings management techniques that can be used by a firm to accomplish the firm's objectives, and this range of options can vary by industry.

More widely available measurement options include altering assumptions related to depreciation, adjusting reserves impacting asset valuations, and changing modifying assumptions related to intentions to hold marketable securities. As discussed below, the process of decoding accounting information disclosures to potentially reveal the ethical insights of an organization will involve careful analysis of earning management techniques and the publically available data that can be examined in such regard.

While many of the research efforts discussed above have either explicitly or implicitly validated the ethical aspect of accounting information, each of these works draws on alternative framework when applying ethical reasoning to accounting information. When considering the ethical foundations of accounting information, Frecka (2008), drew upon the ethical intent of SEC and FASB disclosure requirements. Satava, Caldwell, and Richards (2006) drew upon on several ethical theories as fundamental touchstones in an examination of the ethical nature of accounting rules and principles.

Even in the absence of an overall, broadly accepted, ethical framework for GAAP, an analysis of the choices which a corporation makes with respect to accounting information and financial reporting disclosures, including choices which can be broadly characterized as earnings management choices, is a repository of data for obtaining insight into the ethical dimension of a company. As expanded upon below, the next steps in this research stream, after the development of the overall theory, will be to develop and explore specific methodologies to decode accounting measurement choices and financial statement disclosures into ethical information regarding corporations.

One noteworthy legal case which highlights the complexity of analyzing earnings management choices made by management, as well as the multiple functions of earnings management is *Kamin v. American Express Company* (N.Y. App. Div. 1976). As discussed by Gevurtz (2004):

The rationale for the directors' action that the court accepted in *Kamin* was to avoid reporting a loss in American Express' published financial statements on American Express' investment in the DLJ stock, which, in turn, would have lowered the net earnings reported by American Express to the investing public. Such a report of lower earnings, the court reasoned, could lower the price at which American Express stock traded on the market, and hence would be bad for the American Express shareholders. In other words, not only was there nothing wrong with seeking to maintain stock prices by hiding a loss, according to the court in *Kamin*, this goal justified giving up \$8 million in tax savings.

Gevurtz (2004) then comments:

The main problem with *Kamin*, as brought home by the corporate scandals of 2002, is both the court's and the litigants' unqualified assumption that reporting higher earnings to maintain the trading price of American Express stock was a legitimate goal for corporate directors.

The *Kamin* case illustrates not only the complexity and different perspectives that can be brought to bear in the legal analysis of an earnings management event, but also the fact that different perspectives need to be considered when examining the ethics of a

particular accounting treatment. As Arya et.al (2004), stated, not all earnings management is an unmitigated evil.

4.2.7 Accounting and the Public Interest

The usefulness of accounting information as a source of information pertaining to corporate ethics is intertwined with the public ownership of corporations. It is the interaction of the public ownership of corporations with the private interests of firms that contributes to the moral dimension of the accounting choice decisions. While in certain circumstances the private interests of managers may be more obvious, such as incentive compensation plans, knowledge of the specific private interest is not a condition necessary to establish the fact that private interests exist. As noted by Frecka (2008), a private interest may be compliance with debt covenants. Although companies' private interests vary, they exist.

While much has been written about accountants and public interest, and the American Institute of Certified Public Accountant emphasizes the public interest aspects of accounting, there remains no clear, unambiguous approach to comprehending what the public interest is (Dellaportas & Davenport, 2008). An important foundational element of the analysis in this study rests with the role of accounting and accountants as protectors of the public interest (Cheffers & Pakaluk, 2007). In spite of the lack of unanimity and clarity surrounding the precise determination of what the public interest

is and how it is determined and represented, it is clear that public accountants and accounting information have an important role with respect to public.

The public disclosure and dissemination of accounting information, as well as the possible motivation for the management of earnings disclosures, is intertwined with the public ownership of corporations. Public ownership of corporations creates the principal/agent problem where owners and managers of companies are separate, and consequently the need emerges for mechanisms that align interests such that the private interests of managers do not override the interest of shareholders (Berle & Means, 1932; Jensen & Meckling, 1976). In the case of corporations, whose stock is widely held, such principal/agent problem arguably extends beyond the interests of shareholders to a broad array of stakeholders including, as was painfully learned as a consequence of the financial crisis, the taxpayers and the entire citizenry. As a consequence of widespread and dispersed ownership of corporate shares, accounting information and disclosures serve an essential role in providing information to shareholders, stakeholders, and the wider public interest.

It is the public availability of accounting information provided by corporations which makes such accounting information an interesting and potentially important source of study for examining the ethics of a corporation. As noted above, public company financial statements are audited annually by external auditors. Such a mechanism provides reasonable, but not guaranteed, assurance that financial statements are prepared in compliance with the rules and principles that govern accounting. It is the revelation of the choices which companies make in their accounting that may

provide an insight in the ethics of a company. Yet, it is vital, that the set of available choices be limited to those which are generally acceptable within the rules and principles. Such a framework provides the boundaries necessary for considering accounting choice decisions as potential useful sources of ethical insight. Just as unaudited financial statements limit the decision-making utility of financial statements, the utility of such statement for ethical analysis would similarly be diminished if there were no measurement or disclosure boundaries. Yet awareness of the potential lack of conflict between auditor and company is useful because auditors are not paid by those whose interests they protect, namely the public. Indeed, such was the case in several high profile scandals including WorldCom and Enron.

The public interest aspect of accounting, as well as the centrality of accounting information, can be further emphasized by reference to the Sarbanes-Oxley Act of 2002 (SOX). Much like the SEC Acts of 1933 and 1934, SOX mandated changes to the financial system were needed to restore investor confidence in corporate America and reflect the centrality of accounting and accounting information to the U.S. economic system.

Accounting and accountants have a public interest role. It is this role which makes the moral aspects of accounting vital to society at large. Furthermore, not only are the ethics of the profession guided by responsibilities to the public interest, but most importantly the principles which underlie the system of accounting information are guided by a responsibility to public interest (Hendriksen, 1977).

4.2.8 Briloff

Abraham Briloff, as much if not more than any single scholar, has examined the topic of accounting and the public interest. His work reinforces and illuminates the complex interactions between the ethical aspects of accounting and the relationship between accounting information and the public interest. While his focus is often on the failures of accountants, his work is fully consistent with the broad analysis of this paper that accounting information choices have an ethical dimension which is created by the tension between public and private interests. Briloff's body of work embodies the clarion call for deep understanding of the relationship between accounting, the ethics of accounting information, and the public interest. When he examines the covenant between accountants and society and characterizes such a covenant as having been violated, he builds from the statutes which enshrine the special position of Certified Public Accountants as servers of the public interest (Briloff, 1990).

Briloff (1990) analyzed and examined how and why accountants have desecrated this public trust, focusing on lack of independence and the acceptance of "cockamamie" accounting treatments such as those applied in the period leading up to the Saving and Loan crisis of the late 1980's. Accountants need to maintain independence and allegiance to higher principles and ethics, yet the reality is that accounting is a business and accommodating clients often creates tensions and creates circumstances which involved an ethical dimension. Materiality is frequently used as a convenient exit point for ethical discomfort.

When examining the accounting practice of corporations, Briloff consistently returns to the importance of independent auditors as vital to assessing the fairness of presentation of financial information. He returns again and again to the important societal importance of accounting and auditors as counterweights to self-interested managers who may deviate from standards of fairness which form a vital accounting principle (Briloff, 1972). Briloff railed at those who are not vigilant in raising red flags to draw attention to those circumstances which violate the high ambitions of accounting and accounting information principles. Consistent with this view, Briloff criticized the previous COSO fraud report which covered the period from 1987-1997. His criticism of such report was rooted in many factors including an underrepresentation of large accounting firms (Briloff, 2001).

By introducing the most recent COSO report at the beginning of this paper as a basis for examining whether accounting information can reveal ethical insights into corporations, and also drawing upon the work of Briloff, the intention here is to ground this work in multiple perspectives which examine the relationship between accounting information and the public interest, whether or not such works align with one another.

4.3 Ethical Analysis

4.3.1 Ethical Content of Accounting Information

As moral agents, public corporations have the operating skill and hierarchical structure to operate consistent with their morality (French, 1979). Consequently, decisions or actions taken by such moral agents, including those which involve

consideration of both the private interests of corporations and the public interests of shareholders and extended stakeholders, may be influenced by the agents' morality. While accounting information is fundamentally a measure of economic activity, and ethical theory does not formally serve as the foundational theory for the principles of accounting, an ethical approach can be applied to understanding the vital aspects of accounting (Hendriksen, 1977). The selection of accounting information or financial reporting disclosure alternative is one such decision which arguably incorporates such agent's morality. The outcome of such accounting information and financial reporting decisions is generally available in the publically disclosed accounting information and financial disclosures and therefore available for analysis. An analysis of such publically available accounting information and financial disclosures may prove to be a useful source of insight into the ethics of a corporation.

The next step in this research effort will be to begin the development of the specific decoding techniques that can be applied to accounting information to access the ethical content of accounting information. Several alternatives measures that originate in extant accounting research are the focus of the first decoding efforts.

4.3.2 Discretionary Accruals

Current accounting practice is based upon accrual accounting, which recognizes economic events as they occur rather than when cash is exchanged. Research which examines the quality of accruals, discretionary accrual, and abnormal accruals is extensive (Dechow & Dichev, 2002) and generally focuses on improving the measurement and understanding of firm performance.

The information content that a measure of discretionary accrual may offer with respect to the ethics of a corporation is at this point a subject of theory. However, one avenue of research that could begin to test the theory would be to hypothesize that such discretionary accruals may prove useful in an analysis of the ethics of a corporation. Higher levels of discretionary accruals in particular—after control for industry, firm size, and other typical control variables—may raise questions regarding a bias in favor of private over public interests. Similarly, both cross-sectional and time-series studies could begin to provide the decoding data which could contribute to revealing insights into the ethics of a company. There is much complexity and specific technique to be developed; however, this is likely a variable for early ethical analysis.

4.3.3 Measures of Conservatism

Accounting conservatism, a foundational principle for accounting information, has been the focus of substantial research (Khan & Watts, 2009). Much of this research has been devoted to understanding and developing measures of accounting conservatism. Basu interpreted conservatism as asymmetric timeliness of earnings such that “bad news” is reflected in earnings more quickly than “good news” (Basu, 1997). The results of the Basu study, which verified the asymmetric reporting thresholds for gains versus losses, have been extended in several studies. A number of research efforts continue to seek measures of conservatism at the firm level that measure both timing of changes in conservatism as well as the fluctuation of conservatism cross-sectionally. A variety of such constructs have been developed and continue to be explored, each of which seeks to measure accounting conservatism effectively. Khan and Watts have

developed proxies for accounting conservatism (Khan & Watts, 2009) which take into consideration firm-specific characteristic such as size and leverage in addition to Basu's asymmetric timeliness of earnings measure, which for the most part initiated the stream of research seeking to measure accounting conservatism (Basu, 1997).

In addition to being an important measure that may contribute to improved understanding of the financial information of firms, the measure of firm-specific and industry-specific conservatism may offer useful information regarding the ethics of a company. While at this juncture, it is imprudent to state that more conservative accounting is likely an insight into a more moral firm, it is the pursuit of such research questions using measures of firm and industry specific conservatism measures that could prove fertile ground when decoding accounting information in search of ethical insights into an organization. Furthermore, time-series analyses of such measures are another important focus of further examination.

4.3.4 Voluntary Disclosures

Multiple studies have examined voluntary disclosures by corporations including ethical disclosures. Findings include results which suggest that voluntary ethics disclosures, typically disclosures of codes of conduct, aid fraud detection (Persons, 2010). Corporate voluntary disclosures represent choices on the part of managers to provide information beyond that which is mandated. Measures of voluntary disclosure have been developed and empirical studies associate such measures with firm characteristics including size, leverage, governance mechanisms. Whether such disclosures provide useful information regarding the moral dimension of corporation is

a path to consider. Evidence that voluntary disclosures can be associated with managers seeking to convey bad news to the market may indicate that decoding the ethical content of voluntary disclosures may entail complexities that the label voluntary disclosures belies.

Table 4.1: Ethical Content of Accounting Information - Decoder

Measure	Additional Moral Analysis	Delayed Moral Analysis
Discretionary Accruals	Higher	Lower
Conservatism Index	Lower	Higher
Voluntary Disclosures	Lower	Higher

4.3.5 Uses of Accounting Information

Finally, insights into the ethics of a firm can be revealed by examining from an ethical perspective how a firm employs output from its accounting information systems. Examinations including those by Healy focus on the relationship between accounting and executive compensation (Healy, 1985) and is an example of an analysis that raises ethical questions regarding a firm that is based upon an analysis of how a firm employs output from its accounting information systems.

4.3.6 Systemic Implications

While the discussion presented has focused on the ethics of a single firm, the argument is now set forth that such moral information can also be useful when examining a group of firms, be it a sector, a geographic combination or the economic system in its entirety. Sourced from accounting information, ethical insights into single firms can be combined with the results of examination other firms, and the resultant information may be useful at the aggregate level. The possibility of obtaining such insights and combining such insights from different firms introduces the potentially systemic value of such information. Could information on corporate ethics, decoded from the output of accounting information systems, particularly time-series analysis of major financial institutions, have provided insights into the growing risk profile of financial institutions during the period which preceded the financial crisis?

Building upon the theory set forth in this essay, opportunities exist at the private, public and self-regulatory level to pursue the systematic implementation of a process, which identifies, reports and interprets the ethical content of accounting information. As noted above, stringent efforts need to be adopted which assure unbiased analysis.

4.4 Conclusion

In the present day U.S., the foundational principles of accounting are codified in Generally Accepted Accounting Principles (GAAP). The primary objective of GAAP and accounting is to communicate economic information regarding organizations. Within the information system known as accounting there are options and choices that

organizations select. This paper has examined whether the selection of alternative accounting options by corporations can reveal ethical information regarding that organization.

Given the moral underpinnings of accounting principles, the objective of this paper has been to argue that the information captured and publically disclosed by accounting systems can also provide insights regarding the ethical dimension of an organization. Further, such information, when evaluated both cross-sectionally and longitudinally, may reveal important insights and trends regarding the ethics of not only companies, but sectors and the economic system in total. Identifying information that can reveal insights into the ethics of companies may provide information useful for a variety of purposes, including understanding firm economic risk, sector risks or systemic-wide risk.

References

- American Accounting Association. (1966). *A statement of basic accounting theory*. Evanston, IL: American Accounting Association.
- Arya, A., Glover, J. C., & Sunder, S. (2003). Are unmanaged earnings always better for shareholders? *Accounting Horizons*, 17, 111-117.
- Basu, S. (1997). The conservatism principle and the asymmetric timeliness of earnings. *Journal of Accounting & Economics*, 24(1), 3.
- Berle, A., & Means, G. (1932). *The modern corporation and private property*. Macmillan, New York.
- Briloff, A. (1972). *Unaccountable accounting*. Harpercollins, New York.
- Briloff, A. (1990). Accountancy and society a covenant desecrated. *Critical Perspectives on Accounting*, 1(1), 5-30.
- Briloff, A. (2001). Garbage in/garbage out: A critique of fraudulent financial reporting: 1987-1997. *Critical Perspectives on Accounting*, 12(2), 125-141.
- Briloff, A. J. (1981). *The truth about corporate accounting*. New York: Harper and Row.
- Brooks, L. J., & Dunn, P. (2010). *Business & professional ethics for directors, executives and accountants* (5th ed.). Mason, OH: South-Western Cengage Learning.
- Cheffers, M., & Pakaluk, M. (2007). *Understanding accounting ethics* (2 ed.). Sutton, MA: Allen David Press.

- Committee of Sponsoring Organizations of the Treadway Commission. (2010). *Fraudulent Financial Reporting 1998-2007*. Durham, NC.
- Corbin, D. A. (1962). The revolution in accounting. *The Accounting Review*, 37(4), 626-635.
- Dechow, P. M., & Dichev, I. D. (2002). The quality of accruals and earnings: The role of accrual estimation errors. *The Accounting Review*, 77, 35-59.
- DePree, J. C. M., & Grant, C. T. (1999). Earnings management and ethical decision making: Choices in accounting for security investments. *Issues in Accounting Education*, 14(4), 613.
- Donaldson, T. (1982). *Corporations and morality*. Prentice-Hall, Inc., Englewood Cliffs, New Jersey.
- Duska, R. F., & Duska, B. S. (2003). *Accounting ethics*. Malden, MA: Blackwell Publishing.
- Frecka, T. J. (2008). Ethical issues in financial reporting: Is intentional structuring of lease contracts to avoid capitalization unethical? *Journal of Business Ethics*, 80(1), 45-59.
- French, P. (1979). The corporation as a moral person. *American Philosophical Quarterly*, 16(3), 207-215.
- Gevurtz, F. (2004). Earnings management and the business judgement rule: An essay on recent corporate scandals. *William Mitchell Law Review*, 30(4), 1260-1277.
- Healy, P. M. (1985). The effect of bonus schemes on accounting decisions. *Journal of Accounting and Economics*, 7(1-3), 85-107.

- Healy, P. M., & Wahlen, J. M. (1999). A review of the earnings management literature and its implications for standard setting. *13*, 365-383.
- Hendriksen, E. S. (1977). *Accounting theory* (3rd ed.). Homewood, IL: Richard D. Irwin.
- Huang, P., Louwers, T., Moffitt, J., & Zhang, Y. (2008). Ethical management, corporate governance, and abnormal accruals. *Journal of Business Ethics*, *83*(3), 469-487.
- Iyer, A. A. (2006). The missing dynamic: Corporations, individuals and contracts. *Journal of Business Ethics*, *67*(4), 393-406.
- Jensen, M. C., & Meckling, W. H. (1976). Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics*, *3*(4), 305-360.
- Khan, M., & Watts, R. L. (2009). Estimation and empirical properties of a firm-year measure of accounting conservatism. *Journal of Accounting & Economics*, *48*(2/3), 132-150.
- McPhail, K., & Walters, D. (2009). *Accounting and business ethics*. New York: Routledge.
- N.Y. App. Div. 1976. 383 N.Y.S.2d 807 (N.Y. Sup. Ct. 1976), aff'd, 387 N.Y.S.2d 993 (N.Y. App. Div. 1976).
- Palmon, D., Santoro, M., & Strauss, R. (2009). Pay now lose later: The role of bonuses and non-equity incentives in the financial crisis of 2007-2008. *The Open Ethics Journal*, *3*.
- Persons, O. S. (2010). Could investors use voluntary ethics disclosures to assess the likelihood of fraudulent financial reporting? *International Journal of Disclosure and Governance*, *7*(2).

- Rapoport, M. (2010). B of A, Citi made 'repos' errors. *Wall Street Journal*. Retrieved from <http://online.wsj.com/article/SB10001424052748704032704575268902274399416.html>.
- Revsine, L. (1991). The selective financial misrepresentation hypothesis. *Accounting Horizons*, 5(4), 16-27.
- Ronen, J., & Yaari, V. (2008). *Earnings management: Emerging insights in theory, practice and research*. New York: Springer.
- Goldman Sachs to Pay Record \$550 Million to Settle SEC Charges Related to Subprime Mortgage CDO (2010).
- Soares, C. (2003). Corporate versus individual moral responsibility. *Journal of Business Ethics*, 46(2), 143-150.
- Tinker, T. (1985). *Paper prophets: a social critique of accounting*. New York: CBS Educational and Professional Publishing.
- Wettstein, F. (2010). For better or for worse: Corporate responsibility beyond “do no harm.” *Business Ethics Quarterly*, 20, 275-283.
- Weygandt, J., Kimmel, P., & Kieso, D. (2008). *Financial accounting* (6th ed.). Hoboken: John Wiley & Sons.

Chapter 5: Conclusion

This dissertation, focused on the financial system of the U.S., examined the role of the ethics of business and accounting information in the context of the financial crisis of 2008. My interest is in examining questions that probe the ethical aspects of business and markets and that contribute to a deeper insight into the surprising vulnerability of the U.S. financial system which was exposed as a result of the financial crisis. I am also interested in questions that contribute to a deeper understanding that there is an ethical dimension to accounting information and that accounting information can contribute valuable insights into the ethics of business and markets. Three essays have been presented, each of which has examined an aspect of the relationship between the ethics of business and risks to the financial system.

In my first essay, entitled “Cash-Based Executive Incentive Compensation and Net Earnings: Ethical Analysis in Light of the Financial Crisis,” I examined an established financial industry practice and developed an ethical analysis of executive incentive compensation plans that may have rewarded excessive risk-taking by relying on accrual-based net earnings as a basis for cash-based compensation. Whether examined from the perspective of executive compensation theory or an ethical analysis of fiduciary duties and several forms of moral reasoning moral theory, I was unable to find moral justification for such practices. Furthermore, as I argued, such practices have the potential to create moral hazard, conflicts of interest, and unjust outcomes. A noteworthy contribution of this essay was that the ethical analysis was informed by the

use of accounting information. As more fully developed in the third essay, the approach of examining accounting information to inform ethical analysis is one of the fundamental contributions of this dissertation.

The second essay, “Too Big and Too Interconnected To Fail: Historical and Ethical Analysis of the U.S. Financial System,” was an examination of a business system, the U.S. financial system, and presented a historical account and ethical analysis of how the post-Depression U.S. financial system allowed, or even encouraged, individual financial institutions to become “too big or too interconnected to fail.” The essay argued that in light of individual and collective moral hazards, the overall governance framework which protects the financial system should explicitly adopt, as a moral imperative, a standard such that any financial institution could fail without such failure threatening the entire financial system. Failure risk will counterbalance the moral hazards examined in the essay.

The third essay, “The Ethical Content of Accounting Information,” sets forth a theory that accounting information can provide insights into the ethics of an organization. While the primary purpose of accounting information is to provide information on the economic activity of a firm, it is argued that the informational content of accounting measurements and disclosures includes ethical information regarding a corporation. A framework is developed for decoding accounting information such that ethical information regarding a firm can be revealed. From the perspective of the overall economic system, ethical information from company financial reports may provide insights regarding overall economic system risk.

As developed further in the essays, in addition to economics and finance, the ethical aspects of business and market practices—including the role of accounting information—contributed to the crisis, and probing such ethical dimensions contributes to a fuller understanding of the factors that caused the crisis. The overall contribution of this dissertation is in deepening the understanding of these complex and interrelated factors, and in doing so providing a perspective which may be useful in avoiding similar crises. While each essay is a distinct analysis, as an integrated work this dissertation illuminates the complex, multi-layered relationship between the ethics of business and markets, the role of accounting information and the long-term viability of the financial system.

VITA

Ronald J. Strauss

- 1955 Born October 2nd in Queens, New York
- 1972 Graduated from Stuyvesant High School, New York, New York
- 1972-1977 Attended State University of New York - Binghamton
- 1976 Bachelor of Science in Management - SUNY Binghamton
- 1977 Masters of Science in Accounting - SUNY Binghamton
- 1977-1983 Employed by Peat, Marwick & Mitchell, New York, New York - Audit Supervisor
- 1979 Certified Public Accountant – New York State
- 1983-2003 Employed by Merrill Lynch & Co., Inc., New York, New York - Senior Vice President
- 2004-2006 Employed by Spectrum Holdings, LLC, Westfield, New Jersey - Director
- 2007-2011 Attended Rutgers, The State University of New Jersey
- 2011 Ph.D. in Accounting, Rutgers Business School, Rutgers, The State University of New Jersey
-