" The Role of Accounting in Financial Crisis"

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Abstract

The financial Crisis that hit the American economy to its heart in September 2008, rapidly spreading all around the world, has generated strong debates on the use of exotic derivatives financial instruments and of fair value. These themes that made front-page news all over again raised divergent opinions among bankers, insurance executives, auditors or politicians more or less affected by the crisis. This paper aims at reviewing the situation of financial markets, identifying the role and importance of fair value accounting and derivatives within these huge scandals, presenting both for and against fair value and credit derivatives opinions and giving some anti-crisis solutions

For the future .Introducing a group of essays and articles on the implications of the current economic and financial crisis for accounting practice and research, this article provides an overview of some of the principal issues and themes. Noting that very little research has been done on the management accounting implications of such crises, particular consideration is given to exploring the significance of and potential for research on this topic. Drawing on unpublished research and personal experiences, the importance of having a wider understanding of organization's information environment is stressed. Introducing a group of essays and articles the implications of the current economic and financial crisis for accounting practice and research, this article provides an overview of some of the principal issues and themes. Noting that very little research has been done on the management accounting implications of such crises, particular consideration is given to exploring the significance of and *potential for research on this topic. Drawing on unpublished research and personal experiences, the importance of having a wider understanding of an organization's information environment is stressed. The recent financial crisis has led to a major debate about fair-value accounting. Many critics have argued that fair-value accounting, often also called mark-to-market accounting, has significantly contributed to the financial crisis or, at least, exacerbated its severity. In this paper,we assess these arguments and examine the role of fair-value accounting in the financial crisis using descriptive data and empirical evidence. Reflecting the* ***"magnitude"*** *of* ***"financial crisis"*** *in 2008, some academics started examining causal relationships between accounting and the crisis. The purpose of this article is to review the current state of academic research articles related to the global financial crisis that are published in ScienceDirect, Springerlink, Emerald and SSRN databases, in order to identify the trends and researchers' contributions and to analyze the interplay between the global financial crisis and the accounting. Although there are lots of articles about the current financial crisis, the number of academic articles that examine the relationship between accounting and the crisis are still few, but the research questions are increasing, more and more researchers becoming interested in this topic.*

Keywords: *Financial Crisis, Accounting*

Introduction

The Great Recession that started in 2008 has had significant effects on the US and global economy; estimates of the amount of US wealth lost are approximately $14 trillion (Luhby 2009). Various causes of the financial crisis have been cited, including lax regulation over mortgage lending, a growing housing bubble, the rise of derivatives instruments such as collateralized debt obligations, and questionable banking practices. In addition to these and many other reasons, we explain two factors that partially contributed to the crisis: certain management incentives and fair value accounting standards. Following the dot-com bubble in 2000 and the September 11, 2001 attacks, the U.S. economic policies of low interest rates coupled with easy credit, lower taxes, and the cheap dollar generated significant economic growth from 2000 to 2007. Low interest rates motivated many in the United States to pursue home ownership, a goal long propagated and encouraged by the government as a wise investment and worthy social objective. Easy credit facilitated by agencies such as Fannie Mae and Freddie Mac enabled financial institutions to focus on the lucrative subprime mortgage market. Mortgage lenders initiated a growing number of new home loans, many of which were granted to individuals with a poor credit rating, who would eventually be unable to service monthly mortgage payments once interest rates increased. Unfortunately, gains generated from securitization of the home loans and from income on the servicing of the loans inflated financial profits, motivating executives of mortgage origination firms to focus on quantity, rather than quality, of borrowers. Investors, seeking new investment opportunities, fueled the demand for mortgage backed securities that were created through securitization of the home loans. Such securities received high ratings from analysts who also did not correctly assess the underlying default risk.

The current economic and financial crisis has significant implications for accounting, both for practice and for the research community. In the areas of financial accounting, auditing, management accounting and the regulatory institutions that oversee accounting and auditing practices there are genuine worries that the crisis has revealed numerous problems and inadequacies. In the academic and research community it certainly has illuminated issues that are in need of serious research attention. More than that, however, the crisis also points to the rather limited focus of much current accounting research. Too much intellectual inquiry in the area of accounting seems to operate within the parameters set by practice rather than questioning and challenging these, at least from time to time. Although the implications for research in accounting may not be so great as that within the finance research community where the serious lack of critical research is much more visible, a more detailed consideration of the implications of the crisis for accounting research nevertheless points to the need for a more rigorous investment in diverse research perspectives rather than an unquestioned following of a singular mainstream view. In early 2005, interest rates began to rise, increasing up to 8.25% in 2007 from 4% in 2004. In response, a large number of homeowners, particularly those with adjustable rate mortgages, began to default on their monthly payments. In 2007, New Century Financial, the second largest subprime mortgage originator in the US, announced a restatement of its financial statements for the first three quarters of 2006 due to under-reserving certain loan loss provisions. This announcement was followed shortly thereafter by large losses for firms with significant subprime positions, including Bear Stearns, Lehman Brothers, Merrill Lynch, and Citigroup. The market (using the Dow Jones Industrial as a benchmark) dropped precipitously from over 14,000 points in October 2007 to under 7,000 in March 2009, with a drop of almost 2,000 points in one week alone in September 2008. The subprime mortgage woes resulted in a significant and prolonged recession.

The companies engaged in the subprime mortgage business, including both originators/securitizers of loans and purchasers/investors in the securitized instruments, were able to report certain gains on securitization of loans under U.S. accounting standards. Furthermore, companies followed U.S. accounting standards to record loan servicing assets and residual interest assets, as well as certain loan loss reserves, using historical prime mortgage performance to estimate the appropriate value. Finally, purchasers/investors of the securitized instruments accounted for securities under the fair value accounting rules, which permitted the firms to mark (or not mark) certain assets up to fair market value, as measured based on classification of the instrument.

While the actual fair value standards themselves may not have been the culprit behind the financial crisis, we believe that the *inconsistent implementation* and *subsequent misapplication* of the standards contributed in three ways to the financial crisis. Specifically, reporting of immediate gains on securitization facilitated and motivated more subprime lending. Second, some amounts originally selected as Level 1 and Level 2 fair values were incorrect, but once borrowers began to default on home loans, firms switched to Level 3 internal estimates rather than adjusting to the true declining fair value. The ability to use these internal estimates enabled firms to continue to assume risk. Finally, the eventual recognition of losses and the ripple effects through the economy resulted in a large, rapid decrease in the amount of banks' capital. For these reasons, we believe that the misapplication of the U.S. accounting standards had some role in the financial crisis.

The magnitude of this financial and economic crisis calls for a fundamental reassessment of all areas of business and economic scholarship, including accounting research (Arnold P., 2009). The current economic and financial crisis has significant implications for accounting, both for practice and for the research community. In the academic and research community it certainly has illuminated issues that are in need of serious research attention. More than that, however, the crisis also points to the rather limited focus of much current accounting research. (Hopwood A., 2009). **Consequently, the fundamental objective of this paper is to analyze the relationship between accounting and the**

current financial crisis by analyzing and discussing changes encountered in research literature's way of dealing with this topic

Aim of the Study and Research Methodology

The objective of our paper is to provide a comprehensive literature review and overview of the relationship between the global financial crisis and accounting. It was proven that the literature review plays an important role in delimiting the existing research problem in the field of social sciences. Also, the literature review is considered to be the primordial method in distinguishing what has been done from what needs to be done, identifying relationships between ideas and practices, establishing the context of the topic or problem, understanding the structure of the subject, relating ideas and theory to applications, identifying the main methodologies and research techniques that have been used, and placing the research in a historical context to show familiarity with state-of-the-art developments. (Ray B., 2002) The discussion focuses on four scientific Journal databases: ScienceDirect, Springerlink, Emerald and SSRN, identifying the trends and researchers actively contributions to the development of our topic of research. For performing the analysis of literature we selected all the international journals on accounting and economics area, form the aforementioned databases, followed by the selection of papers dealing with the interplay between accounting and crisis. Also, we defined three sets of variables representing various features of journals, papers published and their authors. Finally, basing on empirical results revealing these features influences over international literature, we concluded our study by discussing the changes in general trend of research caused by the financial crisis.

Review of Literature

"(Previts& Merino, 1979)" "A classical period of thought and practice, as delineated by the events surrounding the great depression of the late 1920s and early 1930s, marks a maturity point in American accounting

"(Stefanescu C., 2011:)"the wide range of governance failures and corporate scandals encountered over time brought this concept to the attention of media and academic environment, transforming it into an increasingly challenging topic of worldwide research

"(Tomkins, 1978)"Transformations in accounting knowledge and practice have been influenced by many factors, such as economic, social and political pressures,

“(Tomkins, 1798)”Transformations in accounting knowledge and practice have been influenced by many factors, such as economic, social and political pressures, (Tomkins, 1798) ad hoc influences like wars, periods of economic decline and labour disputes

“((Hoogervorst, 2002:)”Also, Hans Hoogervorst, the Chairman of the International Accounting Standard Board, claims that “it is a sad truth that most initiatives to strengthen the international financial architecture to reap the fruits from the on-going liberalization of capital movements have been taken under the pressure of some kind of crisis”

“(Laux C. and Leuz C., 2009)”Financial Reporting Standards had very little to do with the causes of the crisis. The real cause of the crisis was the massive overleveraging of the economy as a whole and the undercapitalization of the banking sector in particular. And if there were problems with transparency, these were to be found principally in the capital requirements imposed by banking regulators

Conclusions

As this crisis has shown, accounting standards can have huge implications for the outside world, so the outside world should have the opportunity to have a say. This is especially the case now that public authorities have become so important in the worldwide acceptance of standards. We can conclude that the accounting community has spread in two: the ones that blame FVA and consider it for been a factor that causes the financial crisis and the ones that praise FVA. This literature review was conducted by searching in four online databases, during 2008- 2012. The summary and information regarding the relationship between accounting and crisis, related articles were kept in both SPSS and Word, in order to facilitate detailed analysis. The aim was identifying the trends and researchers actively contributions to the development of accounting and accounting regulations during the global financial crisis. This review of the literature will be further developed, intending to include at least other four online databases: Wiley Interscience, JSTOR, Highwire and EBSCO and to perform a broader analyze on “accounting” and “crisis” related articles, including the authors’ origin, research methodology and so on.

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