The role of accounting in the global financial crisis. Assumptions and realities

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Abstract: The financial crisis prompted some players to denounce the role of financial markets "fair value accounting" required by the accounting rules used by the major listed companies in the world, U.S. GAAPs in the U.S. and IFRSs in Europe. This paper is related to the link between accounting and the global financial crisis. As technical research, we use the procedure of reviewing the literature. The criticism of fair value accounting are considering in particular two problems: the lack of liquidity (as may be assessed on the balance sheet financial instruments not traded in the market) and the pro-cyclicality (emphasizing the economic phases of expansion and recession). These difficulties are real, but the solutions offered - temporary or permanent modification of existing rules in order to limit the scope of this method of accounting – are not at all convincing. Although it is easy to identify gaps in fair value is still more difficult to propose an alternative option to respond more effectively to the requirements of relevance, reliability, comparison and understanding necessary for financial accounting rules In particular, the reference to historic price, often raised, would provide more than comparable and much less relevant.

Keywords: financial crisis, accounting rules, fair value, historical cost

1 Introduction

Until 2007 banks in the United States and around the world competed to provide loans. Certainly, this is their reason to exist and that they live, only that many banks offered loans (all who asked, even if the payment history and income were it not favorable customer) that, at a time, not May resist their pressure. epicenter of the global financial earthquake are located in the United States, where the collapse occurred on activity called subprime loans (loans with a very high risk). Interpenetration of the existing global financial system has triggered a chain reaction. Fall of the American housing market has caused the bankruptcy of credit organizations, little attention to quality customers. These companies credit fragmented their claims in complex and risky financial products distributed directly or indirectly, by almost all financial institutions in the world (Lewis, 2009).

The fear caused by these risky products generated a crisis of confidence which has triggered panic on the stock markets. Persistence quotes and worsens the crisis led to decrease in the value portfolio and capitalization companies, followed by a reduction in consumption, which had a negative impact on economic activity (Melvin, Taylor, 2009). Gradually passed from a local real estate crisis to a global crisis of the financial and industrial system, exacerbated by the inflation in developing countries (Spence, 2009).

2 Research methodology

This paper is related to the link between accounting and the global financial crisis and it presents the basic research. The objective is to examine the possible role of accounting rules and practices in the onset and deepening of financial crisis. In terms of epistemological discourse, this approach is of a regulatory type. As technical research, we use the procedure of reviewing the literature. As a conclusion, we tried to offer an answer to the question: abandoning fair value may be a possible solution for the crisis?

Our approach is divided into three sub-paragraphs: the accounting – a determinant of the crisis, financial crisis and the silence of auditors debate on the fair value.

3 The accounting – a determinant of the crisis?

In addition to economic or other causes of the crisis, stated that an important part of the blame should belong to accounting, caught on the wrong foot in many situations (Vernon, 2008). Accounting practices are involved in the current financial crisis in several ways. The most obvious is the financial reporting requirements governing the assessment of assets and off-balance sheet entities (Ryan, 2008). The importance of these accounting rules is underlined by the fact that the solvency and survival of most financial institutions depend on how accountants evaluate bank assets and the extent to which the auditors require companies to include in the consolidation perimeter and off-balance sheet entities (Arnold, 2009). It is clear that, for example, leaders of a group wishing to appear in its balance sheet liabilities as little debt as possible, more often if this group is in difficulty and that they must find new financial resources. Thus, it may be tempting for them to remove certain liabilities in the accounting area and to put "off balance sheet" (off balance sheet). This is possible by transferring a particular company created for this purpose, an ad hoc entity, a special purpose entity (SPE), the debts and assets that enable their remuneration, such a company is not viable unless intake is return on assets higher cost of debt transferred. Clearly, the operation is not interesting in terms of financial picture than if the company thus created remain outside the perimeter of the group accounts. It is necessary therefore to normalize the force to consider this issue. The leaders of Enron were able to "play" with the provisions of U.S. normalization of the time. In principle, such entities are included in the accounting area groups unless the participation of other shareholders in these entities represent at least 3% of their assets (rather low threshold) and their leadership was one of these other shareholders. All the "cunning" Enron managers was the development of a large number of SPE, around 9000, which meets the two conditions, at least on first because in the second, proved that, often, these entities were run Enron employees and, in particular, the financial director of the group. Consequently, these companies do not appear in published accounts of Enron (Colasse, 2008).

4 Financial crisis and the silence of auditors

Increasing financial capitalism has questioned the basic skills of auditors (Sikkim, 2009). For over a century auditors use concrete ways things can be examined, counted and measured and their values can be verified on the basis of invoices and vouchers. This view was contradicted by complex financial instruments (e.g. derivatives) whose value depends on uncertain future events and can range

from zero to several million dollars / pounds. Derivatives were determined for the collapse of financial and non-financial companies such as Barings, Enron and Parmalat (Horomnea, 2009, pp 285 to 301).

Attention has focused on auditors as they are considered "green light" given by the auditor that is equivalent to an entity's financial statements are prepared in accordance with accounting standards and offers a true reality. But it seems that companies worldwide have received unqualified opinions on their financial statements and that only shortly before public disclosure of major financial difficulties that are. These views were provided by one of the Big Four accounting firms - PricewaterhouseCoopers, Deloitte & Touche, Ernst & Young and KPMG.

An important issue identified by experts in the field (Humphrey, Loft, Woods, 2009) is that the annual report, despite its length (the length of annual reports from the banking sector often exceed 300 pages), not mentioned only that the financial statements Annual comply with the rules. Reader of financial statements is not providing information on how this line has been evaluated or tested by the external auditor. There are various ways in which the substance and quality of audit work could be demonstrated. For example, a section of the annual report the company may focus on key findings of the audit. It could include information on operational levels of audit risk, the materiality, the significant errors detected, and information on the scale, nature and results of tests performed to check the value of assets accounted for under the rules market, market to market or to pattern. Such disclosures could include technical assistance and information about the company by the auditor.

5 Debate on the fair value

Degradation of the global financial situation has led to a crisis of valuation of assets and liabilities, particularly those held in large quantities by banks. Indeed, financial institutions have had to reassess their portfolios at a lower value, thereby contributing to worsening feelings of mistrust. Valuation at fair value is in center of many debates between supporters and opponents of Anglo-Saxon conception of accounting. Although the valuation of assets at fair value was presented by its promoters as a guarantee of transparency, the current finding is that financial institutions no longer trust in others and some give only one level of impairment relative credibility of the portfolios held by their competitors (Mullenbach, 2008). People who disagree with this see fair value like a door open for potential assessments roads and to introduce volatility in the financial statements of companies (Sacarina, 2008).

5.1 About the fair value generally

U.S. credit crisis that has spread rapidly in all financial markets, has generated numerous questions about the calculation and reporting of asset accounts listed companies and thus have emerged criticisms of accounting rules, in particular the International Financial Reporting. These standards attaches great importance to the economic value of the company compared to its value heritage. For this reason, they propose using the fair value method of valuing assets and liabilities. Fair value is defined in the content standards developed by the IASB as "the amount that can be traded one asset or a liability settled, voluntarily, between the parties to knowingly, in a transaction where the price is objectively determined on the market. She opposes the assessment at historical cost which is keeping the financial statements at face value accounted for the transaction date. The fair value, valuing certain assets and liabilities at market value, gives the reader a firm's financial statements clarifying new and more economical than traditional methods.

5.2 Critics of fair value in the current economic context

The current financial crisis is unique in that many companies have had to stop work, although they had problems of liquidity but rather solvency problems due to application of the rule book to market value assessment. Because of this accounting rule under Mark-to-market and associated accounting concept of "fair value" (fair value) have been incriminated as key factors in explaining the crisis. In times of crisis, fair value is the economic reality but not market risk. Thus, accounting rules have changed and the difficulties banks have offered to shareholders and investors with a view "real time" over the degradation of their financial situation.

As long as markets are liquid, are assets and liabilities are easily and rapidly changed the market, the application of fair value does not present difficulties. However, in a situation of low liquidity, the application of fair value becomes very complicated. Degradation of the global financial situation has led to a crisis of valuation of assets and liabilities, particularly those held in large quantities by banks. Indeed, financial institutions have had to reassess their portfolios at a lower value, thereby contributing to worsening feelings of mistrust.

Criticism of fair value refers to how the first counting, the current crisis, the complex financial products. Market conditions existing in August 2007 after leading to an imbalance between supply and demand imbalance is reflected in a crisis of liquidity and price outliers without regard to the fundamental value that corresponds to the potential for generating future cash flows associated with ownership of securities . Items available for reference pricing - for example, ABX indices (asset backed index) publish the financial information company Marki - have suffered a strong decrease in value after August 2007. Those are the elements of comparison, when they exist, which are required by accounting rules as a reference for assigning a book values of financial instruments have become less liquid (when there is such a means of comparison, the issuer may use an internal model assessment to determine the carrying amount of that instrument, these models are usually based on subjective estimates and a suite of hard verifiable (Deaconu, 2009, p. 107)). This applies to the rules applied in Europe and for the U.S.. To understand the consequences of this present evaluation accounting rules still an example. A bank holding $ 100,000,000 in mortgage securities, according to data recorded in the accounts at December 31, 2007. Following the crisis, such securities market is collapsing. On December 31, 2008, to evaluate these instruments, the accounting must be guided by market value. But following the disappearance of liquidity, they determine the value of these securities only $ 25,000,000. The bank must record a loss of $ 75,000,000 in both the result and the account balance. Capital and bank assets were reduced by $ 75,000,000. It is noted that the institution bears a heavy loss, but this involves only a paper loss, in fact he will not miss one U.S. dollars until they will sell those securities.

Accounting at market value would be expressed by an accounting loss unjustified economic fundamentals, which reduce bank capital more than that. Therefore, this rule book creates a vicious economic circle (Bernard, 2009) because they require low capital banks to reduce lending, a situation which stifles the economy. It degrades, diminishes the market prices of assets, which further reduces the banks' capital (Arnold, 2009). Even in a normal period, this rule is a pain. Thus, it contributed to the climate of economic euphoria of recent years. When the economy and financial markets function well, the value of assets is increased and, therefore, capital increases and financial companies.

The financial crisis has brought to light to the criticisms of international accounting standards regarding the potential volatility of the financial statements that might cause a fair amount. Extreme fluctuations in financial markets over the past two years have increased volatility in financial

institutions which boosted investor perceptions, regulatory bodies and governments of the seriousness of the crisis. It registered lower profits reported by some companies is even more dramatic if one takes into account the record profits achieved in previous years and that the evaluation at fair value resulted in a reduction of benefits the current period. The following example illustrates the effect that fair value accounting has on the volatility of reported results. On February 12, 2008 Credit Suisse said profit for the year 2007 a record 8.5 billion francs. On February 19, 2008 the financial institution announced that following further checks of the revised price of certain securities backed by assets and the total write current fair value of these securities was 2.85 billion U.S. dollars U.S.. On March 20, 2008 announced that its operating result decreased by 1.18 billion francs, Swedish (789 million francs after tax) as a Ecart occurring almost 10% compared to figures announced previously. Credit Suisse experience illustrates difficulties in determining the fair value of many assets and that because the methodology of evaluation is complex and depends on many assumptions about the future.

Another critical concern “cycle" induced by the principle of fair value that enhances the apparent strength of bank balance sheets in the phases of growth and a decrease in the downward. In other words, when all goes well, the fair value emphasizes the impression of value creation but the market narrows, the fair value accelerates the process of falling. It is questionable whether the principle of fair value, not only when it is applied to financial instruments become less liquid markets due to imbalance but in a more general, even when applied to all financial instruments.

5.3 Abandoning fair value - a possible solution for the crisis?

Economic analysis has shown, after several decades of experience, that markets are often imperfect, even in times "normal", and especially in times of speculative growth or, conversely, widespread panic, especially because information asymmetries and differences in mentality and behavior of various participants. While it is easy to highlight the negative effects inherent in assessing the market prices are less easy to identify an alternative accounting method that would better meet the objectives of relevance, reliability, comparability and understandability, commonly cited as a guide in preparing accounting rules. Valuation at historical cost, often cited as an objective solution, provides less information comparable and, especially, much less relevant. It leads to a systematic undervaluation of assets since it does not take into account the effects of rising market prices. The information reflected in the accounts is therefore a lower value for users of financial information and, especially, the main users are investors (Deaconu, 2009, p. 123). Evaluation notional price fixed by public authority enjoys credibility and lower, at least for most economists and leading capital markets participants. When the market is liquid and active, the idea that the book values could be maintained above the market price goes against the principle of prudence and not stand silent while. So based on market value accounting allows companies to publish results that are more relevant and comparable than those obtained using other accounting estimates.

And in terms of less liquid financial instruments is difficult to provide credible alternatives to current options accounting standardization, themselves the result of a long line of trial and error over many decades. One option often raised is to replace the reference to "comparable instruments, located in the center of the current difficulties related by financial innovation complex products by using an internal valuation model or mark-to-model. Using a model of transparency may be a factor if accompanied by detailed information on features and tools modeled on assumptions considered. But generally, it offers business leaders an unequal liberty to determine the key tools of modeling future financial flows and discount rates and, therefore, determined the value changes based on the model for a given financial

instrument. Therefore, most users consider that the reference to the financial information market, as long as it exists, even if imperfect, is generally preferable to an internal model prepared by the issuer.

Today, accounting standards remain the core of the discussions, so that one of the conclusions of the Eurogroup of crisis October 12, 2008 is based on the failure of accounting rules in the financial system. It already made one concession, despite the stated attachment to keep steering the fair values assessments, recommends the adoption of a coordinated action to ensure "sufficient flexibility in the implementation of accounting rules, allowing them the entities and financial institutions to evaluate assets "based on assumptions about the non-associated risk rather than immediate market value which, in a market not liquid might not be appropriate. Faced with these criticisms, on November 12, IASB issued IFRS 9. It shares financial assets held by a firm in two categories: those that are valued at amortized cost and are valued at fair value. In the standard model are analyzed to determine the eligibility of a financial asset for valuation at amortized cost. To this purpose shall be fulfilled two conditions: first to assume that financial assets held for collecting and holding cash flow are not for sale. Secondly, to be eligible for assessment at amortized cost, assets must generate cash flow and interest rate to represent. It also refers to the evaluation standards of equity instruments. Thus, they will be measured at fair value on the balance sheet and changes in value in the income statement as gain or loss, except those capital items for which the entity has already chosen as the changes in value are included in the overall result (other comprehensive income).

6 Conclusions

The financial crisis has brought to light to the criticisms of international accounting standards regarding the potential volatility of the financial statements that might cause a fair amount. Therefore, accounting was not completely innocent in the outbreak and spread of the crisis. She amplified the illusion of continuous growth and has helped increase the value of spiral balance of assets. It also accounts played an important role in increasing vulnerability of corporations in the process of attracting capital from different financial institutions and facilitated excessive cash outflows (McSweeney, B., 2009). However, fair value is not guilty in U.S. subprime crisis. Culpability rules circulated fair value is based solely on their pro-cyclical nature, ie the increased phase Expanse and economic recession. In other words, when all goes well, the fair value emphasizes the impression of value creation but the market narrows, the fair value accelerates the process of falling.

Finally, the source of the problems that generated the crisis was really one of evaluation. This is not the accounting evaluation, but evaluation of properties mortgaged when banks gave mortgages.. Furthermore these claims were overstated by financial instruments spread. Therefore reflect the fair value losses they generate and not avoiding a fair value would mask problems, prolong the crisis, but would not solve, such breaking or dismantling "thermometer accounting" would have no therapeutic effect on the status of "patient" and make the more difficult work "doctors".

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