Global Credit Crunch and Accounting*

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ABSTRACT

The concept of economic crisis is accepted to have entered management literature following the 1929 economic crisis. Can accounting be blamed for economic or financial crises? Is it fair to say that a defect or negligence in accounting and auditing played a role in the occurrence and rapid dissemination of the current global credit crunch? In other words, is it possible to find a link between the reasons for or results of the global financial crisis and the basic principles of accounting, the generally accepted accounting principles, the prevalent accounting approaches, methods and practices, the regulations on accounting, accounting audit and any relevant professional or legal regulation and accounting culture and values?

The objective of this communiqué is to open the above-mentioned questions up for discussion. The answers to these questions are quite important, in that they will provide clues that can be used to shape the future of accounting and auditing. This study is expected to be inspirational for further empirical studies to be carried out in this domain.

Key Words: *Global Credit Crunch, Accounting, Auditing, Accounting Standards, Accounting and Auditing Profession*

JEL Classification: *M41, G01.*

Küresel Finansal Kriz ve Muhasebe

ÖZET

Ekonomik kriz kavramının genel anlamda 1929 ekonomik buhranı ile birlikte işletme ve yönetim literatürüne girdiği kabul edilmektedir. Peki, yaşanan ekonomik veya finansal krizlerde acaba muhasebenin bir suçu var mıdır? Bugün içinde bulunduğumuz küresel finansal krizin ortaya çıkmasında ve kısa süre içinde tüm dünyaya yayılmasında muhasebe ve denetimin bir kusuru veya ihmali söz konusu mudur? Diğer bir anlatımla muhasebe temel kavramlarının, genel kabul görmüş muhasebe ilkelerinin, en yaygın muhasebe yaklaşım, yöntem ve uygulamalarının, muhasebe standartlarının, muhasebe mevzuatının yani muhasebe ve denetim ile ilgili yapılan her türlü mesleki ve yasal düzenlemelerin küresel finansal krizin nedenleri veya sonuçları ile ilişkilendirilmesi mümkün müdür?

Bu bildirinin amacı yukarıda sorulan soruları tartışmaya açmaktır. Bu sorulara verilecek cevaplar muhasebe ve denetim mesleğinin geleceğini şekillendirebilecek ipuçlarını taşıması bakımından oldukça önemlidir. Çalışmanın gelecekte bu konuda yapılacak ampirik çalışmalara ilham kaynağı olabileceği umulmaktadır.

Anahtar Kelimeler: *Küresel Finansal Kriz, Muhasebe, Denetim, Muhasebe Standartları, Muhasebe ve Denetim Mesleği*

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I. INTRODUCTION

Along with the financial liberalization movement –-especially- since the 1970s – the financial sector has entered an era of enormous development and has gained a global dimension. During this period, barriers to international capital transfers have been removed and economic policies enabling the integration of international capital markets have become widespread. Though the move towards financial liberalization has accelerated the globalization of the world economy, it has also increased global interdependency, which has significantly hindered countries in determining their own economic policies, hyper-sensitizing them against economic developments and fluctuations.

The rapid pace at which the financial markets have become interconnected has reaped lasting benefits for national economies, investors and savers alike, but has also spawned relatively new risks by changing the structure of the markets (Hausler 2002: 15). Financial liberalization has played an important role in both the onset and spread of financial crises (Özkan, 2008: 2), with crises arising more frequently than ever, with one crisis beginning before the previous one has ended. Moreover, a financial crisis that is specific to one industry and/or country is now able to spread instantly throughout other industries and/or countries as a result of the financial system gaining a global dimension. As can be seen in the last financial crisis (referred to as the "Global Credit Crunch" by many), it is almost impossible to detain a crisis or its effects in its point of origin.

On the other hand, as financial liberalization programs in many different countries have negated financial auditing, an artificial environment of financial independence – one that allows the financial sector to develop more rapidly than the real economy – has emerged. In this free environment, the diversity of financial activities and instruments has increased enormously, however an adequate and efficient technical infrastructure for their evaluation and the assessment of their inherent risks has yet to be formed. Besides this, sanctions on national central banks, banks and other financial institutions have been weakened due to the internalization of markets, leading to an increase in the fragility of financial markets, laying the groundwork for crises in the future (Özkan, 2008: 71).

May accounting be responsible for the emergence of financial crises? May it be the fault and/or negligence of accounting that is responsible for both the emergence and contagion of the global credit crunch? In other words, is it possible to associate the crisis with the fundamentals of accounting, with generally accepted accounting standards, with various kinds of accounting approaches and methodologies, with vocational and legal accounting arrangements etc.?

The aim of this study is to find answers to these questions. A search for the relationship between accounting & auditing and financial crises, if any, necessitates a brief description and analysis of what exactly a financial crisis is. In this regard, firstly, a general analysis and evaluation of economic and financial crises will be made, followed by a broad discussion of the role of accounting and auditing in the emergence of crises and their resolution.

II. FINANCIAL & ECONOMIC CRISES AND THE GLOBAL CREDIT CRUNCH

There is no consensus on the definition of "economic crisis", as it may sometimes be characterized as a "slump" or "recession", and sometimes by "inflation" or "deflation". The major impacts of economic crises may be summarized as significant decreases in consumer demand and investments, high unemployment rates, and consequently a decline in living standards. Also, uncertainties in financial markets and a decline in share prices may be considered as other negative impacts of a crisis (Eğilmez, 2009: 48). Regardless of the reason, a set of comprehensive problems that affect the entire economic structure and change economic activities, either partially or totally may be referred to as economic crisis (Aktaş *et al.,* 2009: 11).

Economic crises may geographically be classified as below (Eğilmez, 2009: 52–53):

- ✓ *Industry-specific economic crisis:* Limited to within the industry from which the crisis arises. A natural disaster in a touristic region may be given as an example.
- ✓ *National economic crisis:* Limited to within the country from which the crisis arises. If this country has a relatively small economy and a limited amount of global trade, the effects of the crisis may be limited to within the borders of that country or within the countries that have close commercial relations with the country of origin.
- ✓ *Regional economic crisis:* Arises when a crisis in a particular country spreads to neighboring countries. The 1997 Asian Financial Crisis may be given as an example. This crisis first emerged in Thailand, before spreading to Singapore and Hong Kong, both of which bore signs of contagion.
- ✓ *Global economic crisis:* Crises emerging in especially big economies that spread globally more rapidly. The fact that most countries have adopted a market economy and have set in place financial liberalization policies has made it easier for crises to evolve. For example, the crisis that emerged in the United States in 2007 and then leapt to England as a mortgage crisis had transformed into a global crisis by the 2nd quarter of 2008, affecting the entire world (Eğilmez, 2009: 52–53).

In principle, a financial crisis is a result of instability in the general economy (Şakrak, 1999: 48). It may sometimes result directly from the financial sector, and sometimes from non-financial sector, that is, the real economy. As a result of financial liberalization tendencies the crises of the last one or two decades have been predominantly financial in origin, and may be defined as "serious economic problems arising from severe price fluctuations in financial markets as foreign currency or stock markets and/or excess increases in bad loans" (Kibritçioğlu, 2003: 3). These crises mostly arise with the speculative attacks of financial investors due to their feelings about the riskiness of economic conditions, and deepen with the intensity of these attacks (Şimşek, 2004: 64).

It is possible to classify financial crises under four headings (Özer, 1999: 29; Yıldırım and Gülcemal, 2009: 145):

- ✓ *Monetary crisis:* Occurs if a speculative attack results in devaluation, and if the monetary authority has to defend the local currency by using large amounts of foreign exchange reserves and increasing interest rates.
- ✓ *Banking crisis:* Occurs if banks suspend meeting their liabilities or go bankrupt; and/or if the public authority attempts to prevent this situation.
- ✓ *Systematic financial crisis:* Causes great destruction in financial markets by breaking the market mechanism.
- ✓ *Foreign debt crisis:* Occurs in cases of detention of foreign debts of both the public and private sectors.

The global crisis that occurred in the United States in September 2008 and then gradually diffused around the world affected not only the US economy, but also the economies of other developed and developing countries. The securitization of high-risk mortgage credits (and other similar financial instruments) has been blamed as the fundamental reason for the crisis. Along with the loss of trust in these instruments, their values have decreased causing deteriorations in the statements of financial intermediaries. Inevitably, the crisis emerged.

The underlying reasons behind the crisis may be summarized as follows:

1. *Abundance of Liquidity and Risky Credits:* The long-term low interest rate policy of the US government caused enormous and rapid increases in especially real estate prices, and disinclined the public to save. Banks, in this period, began lending to low-income and even jobless people. The rise in popularity of such loans – also known as NINJA (no income, no job, and no asset) loans – was another reason for the increase in real estate prices. As a result of credit defaults related to these loans, the portion of distressed mortgage credits in the banks' portfolios soared. As the banks' supply of these real estates into market banks has led housing prices to fall drastically, and inevitably the value of the real estate fell below the value of the related credit payments. As a result, the mortgage debtors halted payments.
2. *Securitization:* In the 2000–2006 period, due to an abundance of liquidity US consumers began being over-credited; and in the same period securitization began to be promoted due to risk-sharing alternatives, desires for higher returns, variety of means provided for banks to meet their legal capital requirements by the government, and instruments that enabled banks to finance fresh credits without additional deposits (Aslan, 2008: 11). Securitization simplified the transfer of risk from one lending institution to another, however especially in periods of crisis; the securitization mechanism makes financial systems more fragile (Alantar, 2008: 78).

3. *Transparency Problem:* In most developed countries, including the United States, the number and variety of financial institutions and financial instruments have increased considerably, and complicated interactions have developed among them (Madura, 2001: 444). As this complexity complicates the understanding of the nature of these instruments and their inherent risk, there also exists a serious problem of transparency. For instance, in the crisis of 2008 it was not possible to determine the variety and real value of banks' assets, and even their acceptors were not able to be determined transparently. This transparency problem laid the foundations for the crisis by mystifying the analysis of these mentioned banks' assets and the calculation of their inherent risks (Wasserstom, 2008).
4. *Rating Agencies and Regulatory Institutions:* As rating agencies are mostly financed by the banks and other financial institutions that they rate, their objectivity may be arguable. In addition, they are sometimes unable to identify financial problems, and/or when they are, identification may be partial or delayed. Prior to the Global Credit Crunch, many of the rating agencies failed to operate effectively, and unfortunately decreased ratings after the beginning of the crisis. It has also been observed that regulatory institutions, including the Federal Reserve Bank (FED), delayed taking precautions against the volatile risk. Additionally, the SEC (Securities and Exchange Commission) Hedge Fund Regulation had been discharged by the US Supreme Court.

Though countries that share more than a half (55%) of the world's gross domestic product (GDP) are known to be the originating points of recessions, and financial and banking crises, it may be emphasized that the countries affected most from these crises are those with high current account and budget deficits, and high short-term currency liabilities (Roubini, 2008: 13).

Other causes of crises may be related with a "weakness of national financial markets, deficits of balance of payments and current accounts, flexibility for fiscal discipline and inadequacy of financial auditing and control" (Emir and Daştan, 2003: 52). Furthermore, according to Akgüç (2009: 6-8):

1. ***The crisis is a reflection of the financial crisis in the real sector:*** The crisis is, in fact, the crisis being experienced by investment banks. The high numbers of worthless (toxic) movable properties in the banks' assets, as well as the losses caused by the provisions, has led to capital insufficiency and have caused banks to fail in fulfilling their responsibilities. The use of hedging techniques for speculative purposes has further increased the risk. Investment banks in the United States and in Europe have sold their existing loan receivables in order to grant more loans, and have thus acquired new sources (derivative products for hedge funds), with which they have furnished new loans (Daştan, 2009:61). The size of the global economy is estimated to be around 64 billion USD, while the hedge funds hit approximately 500 million USD in 2000 and

reached 2 billion USD in 2007, and derivative products increased to 120 billion USD from 20 billion USD (Han, 2008:5). In short, derivative products have almost doubled the size of the global economy. Akgüç (2009) states that the hedge funds amounting to nearly 2 billion USD may account for the short-term capital movements.

2. ***The expansion of the balloon in the US real estate sector into the financial sector:*** The rapid economic growth over the last ten years, as well as the expansion of liquidity, paved the way for a rapid price increase (known as a balloon) in the real estate market in particular. Ertuna (2009: 6) explains the financial crisis as a shift from such speculative prices to real values, and suggests that the crisis actually resulted from the panic triggered by this shift. As the balloon started to deflate and prices began to fall in the United States, there occurred an accumulation in real estate stock and loans were not being repaid. As a result, financial institutions dealing with mortgages made losses and became unable to fulfill their commitments. This had a domino effect across the entire financial sector, and then gradually spread even further.
3. ***The crisis created by the capitalist order:*** Marxist analyses suggest crises are a natural consequence of the capitalist order. In brief, this is a crisis of capitalism, the main reason for which is the ambition to make excessive profit and capital accumulation (Önder, 2009: 25).

In addition to such angles, it is considered that the crisis should be questioned also from an ethical point of view. Would it be fair to say that a deviation from ethical and human values laid the foundations of this crisis? Has this crisis shown that there has been an alienation from reality? Will this crisis lead to the unraveling of the secret? Is it possible to say that this crisis is, in fact, an ethical crisis that merely resembles a financial-economic one? It is generally accepted that the current crisis is a result of previous financial practices and economic decisions. Given that, to what extent are the practices and decisions in question ethical? The answers to these questions may lead one to believe that this crisis is an ethical one, even if only partially.

Another issue to be discussed is just how fair and ethical the practices applied to banks and financial institutions during a crisis are. Such practices are known as "*privatizing profits and socializing losses*" (Ertuna, 2009: 10). Society is made to settle the bills of the companies that are about to go bankrupt, and in this context the relationship between "*asymmetric risk*" (Ertuna, 2009: 10) and *"asymmetric information"* (Şen, 2006: 1-24) should also be discussed. According to some, understanding these two concepts will help us better analyses and understand financial crises.

The IMF has revealed that the losses resulting from the latest credit crunch have reached 2.7 billion USD in the United States, 1.2 billion USD in Europe and 150 billion USD in Japan; and it has been estimated that the total loss will exceed approximately 6 billion USD in 2 years. The link between the last global financial crisis, which has led tens of banks, financial institutions and several giant companies to go to the wall, primarily in the United States, and auditing and accounting is examined below.

III. ACCOUNTING, AUDITING and FINANCIAL CRISES

Having reviewed the crisis itself, now we turn to the crisis of accounting. Is this crisis a crisis of accounting? Can accounting and auditing be blamed for the current financial crisis? For example, may a mistake or negligence in accounting and auditing have facilitated the emergence and spread of this global financial crisis? More clearly, is there a connection between the reasons or results of the global financial crisis and the basic principles of accounting, generally accepted accounting principles, prevalent accounting approaches, methods and practices, the regulation of accounting, and any professional or legal regulation related to accounting and auditing, and the culture and values of accounting?

Above all, when the existing economic systems and financial applications cause a crisis, should accounting and auditing systems, which are an integral part (sub-system) of this system, also be held responsible? Now that economic systems rely on accounting and auditing systems, it would be unwise not to recognize that accounting and auditing systems bear some responsibility for economic or financial crises, even if just a little. The main reason for the failure of financial markets is thought to be the fact that the financial system allows excessive risks, fails to ensure proper pricing and displays weaknesses in transparency (TEPAV, 2008: 2).

It is common for small-scale enterprises to announce their assets and profits as less than they really are, whereas large-scale companies tend to inflate their assets and profits. The reason for this is obvious. Small-scale enterprises have a trouble with the State, while large-scale ones are in trouble with people. Non-public small companies seek to lower their tax base, resulting from the desire to pay less taxes, and put off paying taxes as much as possible; while publicly-listed companies engage in creative accounting practices to hide their losses, swell their assets and show their profit as higher than it actually is, as their concern is to gain access to more and more sources of capital and credit. At this point, the paradox is that everything seems to be in compliance with accounting rules and standards. Auditing companies, credit rating agencies, credit and financial institutions are abused, and can even be made to cooperate; and large enterprises, especially credit and financial institutions, can steer their accounting and audit applications in this direction. Hence, it should be noted that such enterprises may generate pressure on authorized institutions and commissions and influence their accounting legislation and standards. For instance, under long-term pressure from large companies, the cost principle, which is one of the universal accounting concepts, has been replaced by market value (Zeff, 2007: 49–62).

Following the most recent financial crisis, accounting principles and standards have started to be scrutinized (Yılmaz, 2009: 6). Whether or not financial institutions have an effect on IASB and FASB and the functioning of these institutions have both become important topics of discussion (Arnold, 2009: 803–809).

On the other hand, it is claimed that the financial crisis resulted from non-compliance with the concepts and principles of accounting. It is said that "*the non-compliance with accounting principles has laid the foundations of the crisis, and thus the solution must be sought in accounting itself*" (Türker, 2009). It can be observed that the gradual deviation of enterprises from the main concepts of accounting has been influential in the current global crisis. An examination of accounting principles of large companies that have gone bankrupt reveals that the companies in question have deviated from:

- the concept of social responsibility, paying little regard to society as a whole in their accounting organization and processes,
- the concept of personality, failing to distinguish between the vault of the enterprise and the pockets of the owners or bosses,
- the concept of the continuity of enterprise (a.k.a the going concern concept) by having ambitions to make excessive profits, undertaking highly risky businesses, displaying speculative behavior or making investments in such a way that the existence of the company is endangered,
- the concept of periodicity, by applying the capitalization method, using income and expense accruals, extending income or expenses to months/years, or continuously postponing losses,
- the monetary unit standard, by using exchange rate differences and methods of arbitrage,
- the cost principle, by swelling assets through market value management,
- the concept of objectivity, which is abused by the management in the manipulation of financial reports,
- the concept of consistency, by using a number of different accounting valuation options and methods to serve different purposes,
- the concept of full disclosure, through non-transparent practices,
- the concept of prudence, by recognizing unrealized gains and without sparing provisions,
- the concept of materiality, by hiding issues that would sway decision makers, and
- the concept of regularity, through operations and practices that on the surface seem to be in compliance with accounting rules and standards, but are not essentially so.

In this regard, it can be said that the practices being followed do not necessarily comply with generally accepted accounting and auditing concepts, principles, rules, standards and methods for whatever reason, whether it be a lack of professional diligence, knowledge or experience, or incompliance with professional ethics, standards or other legislation. This can be said to have paved the way for the crisis, despite the main goal of accounting being to contribute to the protection of public benefit. The role of American accounting rules in the market troubles should especially be called to question, and even the impact of global accounting principles (Sak, 2008; Sağlam, 2008: Kutlan, 2009: 419–424).

Accounting standards and related regulations need to be restructured in a way that "*prevents convincing lies from being told to societies*" (Aysan, 2009). In this context, the main points that can establish a link between financial crises and accounting and audit are explained in brief below:

Flexibility in Accounting Rules and Creative Accounting Practices

In accounting rules, sometimes several options are offered, and there is room for flexibility. Creative accounting principles, referring to the methods and approaches adopted by enterprises to hide undesirable financial situations and results, have been the main driver of financial crises. The main danger at this point is that everything seems to be in perfect compliance with accounting rules and other related regulations; however the options, flexibility and gaps in accounting legislation, principles and regulations are abused in order to show a false picture of the state of the enterprise.

For example, General Motors (GM), which was established in 1908, declared a profit of 1 billion USD for the first quarter of 2006 although it had actually made a 3 billion USD loss, before going bankrupt in 2008. Their profit declaration was wholly in compliance with American accounting rules, as they benefited from the options and flexibility offered by the valuation rules, and this was repeated in their 2007 financial results. In 2008, they made a loss of 30.6 billion USD, but declared it as 16.8 billion USD using the same method. This giant company, which held a 60% market share with 830,000 employees in the US automotive sector in 1960, was forced to slash its workforce to 275,000 and saw a reduced market share of 25% in 2009. Would the result have been different if the company had declared its real situation to the public? In June 2009 the following explanation was published in the Harvard Business Review: *"For example, if the auditing committee of GM had ensured that the financial tables shared with the public reflect the reality, the company would not have experienced what it experienced (bankruptcy) last winter (winter of 2008), and things would have occurred in a different way"* (HBR, 2009:93 in Aysan, 2009). Beside this, Merrill Lynch, which was acquired by Citibank at a very low cost after it went bankrupt in 2008, had a similar interesting story: "The Company announced that it decreased the value of its assets by 7.9 billion USD in the final quarter financial results of 2007. At the end of the first quarter of 2008 it declared a further decrease of 11.5 billion USD in its assets. This means that Merrill Lynch hid a 19.2 billion USD loss in the value of its assets for years and lied to the public about its financial status. All these lies were in compliance with 'accounting rules'!" (Aysan, 2009).

It is beyond dispute that accounting principles need to be in compliance with accounting principles; yet if this compliance is only for show, then it has no meaning. In both examples mentioned above it can be understood that the principle of regularity was violated, however this concept forbids us from either distorting the truth or diverting from the essence.

Misleading Financial Reporting

Potential investors, credit/financial institutions, clients, suppliers, contractors, shareholders, analysts, external auditors, people employed in insurance, consultants, trade unions, non-governmental organizations (even political parties), courts, media, public opinion, enterprise owners or partners, managers and internal auditors all need financial reporting for different reasons, and it is required that these financial reports comply with reality, standards and legislation and be comprehensible, comparable, transparent, reliable, objective and honestly prepared and approved so that they can serve the purposes of different users. Misleading financial reports and information produced through accounting systems, as well as misleading auditing reports that confirm their accuracy and reliability, must have played a role in the occurrence of the latest financial crisis, must they not? Of course they had a role, and it is impossible to argue against this. It should be accepted that an increase in the number of misleading financial accounts and those who are cheated by them paves the way for crises. An examination of past crises shows that misleading financial reporting played a role in their emergence. For instance, swollen asset values and profits that had undergone audits and approvals played a major role in the crises of 1929–1933, 1997–1998 and 2008–2009 (Aysan, 2009: 10).

Deviation from Prudence and Conservatism

As previously mentioned, one of the most important reasons for the emergence of crises is that accounting practices have become gradually alienated from the fundamental accounting concepts and generally accepted accounting principles. The recent crises resulted from an alienation and rupture from all accounting principles to a certain extent, and it can be understood that the approach of conservatism and the concept of prudence have been greatly violated. However, this concept not only prevents the recognition and reporting of unrealized gains and income, but also stipulates that companies spare provision and register it as an expense. This prevents companies from showing their assets and profits higher than they actually are and offers a conservative (protectionist) approach. In this context, it should be emphasized that permanence in commercial life depends on cautiousness and prudence. Accounting has to reflect commercial life as it is, and an accounting system that is alienated from the principles of commercial life runs the risk of creating a virtual reality (Kutlan, 2009: 422).

The principle of prudence, which is derived from the approach of conservatism and targets the protection of capital and the creditors of enterprises, has overlaps with the continuity concept, and any deviation from this principle endangers the continuity of the enterprise. The role of conservatism and prudence in accounting is best understood when cyclical fluctuations intensify (Kutlan, 2009: 422). It is all too apparent that the principle of prudence has been violated to a great extent in the practices of the US financial markets (Yılmaz, 2009: 7). As a matter of fact, it is inevitable that companies that are moving gradually away from the concept of prudence will go bankrupt sooner or later. WorldCom, the largest telecommunications company in the United States after USA Enron and

Global Crossing, announced its bankruptcy after an accounting scandal valued at 3.85 billion USD dollars was revealed. The bankruptcy of WorldCom, said to be the biggest bankruptcy in US history, was double the size of Enron. According to the *Dünya* daily newspaper on 23.07.2002, the world's largest bankruptcies and the market values of the companies that went to the wall are as follows:

- WorldCom 103.8 billion USD
- Enron 63.4 billion USD
- Global Crossing 24.1 billion USD
- Adelphia 22.4 billion USD
- Kmart 17.0 billion USD

Fair Value Accounting

The accounting practice that drew the greatest attention and the most criticism following the crisis was the fair value method, and there were even attempts to ban the practice (Yılmaz, 2009: 6). This concept, which constitutes a deviation from fundamental accounting concepts and principles, is defined by the IASB as follows "*The amount for which an asset or liability could be exchanged between knowledgeable, willing parties in an arm's length transaction"*. FASB, on the other hand, defines it as follows: *"the estimated price for which an asset or liability could be exchanged between knowledgeable, willing parties who have no collusive relationship in the current market"* (Aktaş and Deran, 2006: 5–6). In a balance sheet valuation, this value does not always reflect the "real value", and the suggested and applied calculation methods for the situations wherein this value cannot be detected are extremely subjective (Kutlan 2009: 419). An examination of the hierarchy that FASB recommends us to follow in detecting fair value reveals this subjectivity more clearly (Aktaş and Deran, 2006: 9):

1. Using published prices for assets and liabilities in an active market,
2. Using published prices for similar assets and liabilities,
3. Using direct market data rather than published prices,
4. Using indirect market data,
5. Using data related to the enterprise.

Following these explanations, we need to ask just how reasonable or just fair value accounting is? (Khoury, 2009). Could it be possible that a "valuation based on market value," which was suggested as a solution to past problems, is in fact the reason for the brutal market reaction today? (Sak, 2008). This approach is clearly against the initial recognition principle; the cost principle, which is one of the fundamental accounting principles; and the concept of prudence; and although while markets are increasing this method may increase profits with valuation assets, when the markets go down, it may accelerate the decline (Wu and Pan, 2009: 135). In the end this may trigger a global financial-liquidity-real sector crisis, which is what we are experiencing today (Kutlan, 2009: 419).

Established after the 1929 crisis, the SEC suggested that valuations based on market value were a "*method to be tried*" (Zeff, 2007: 49-62), and instead imposed the cost management method that remained in place for many years. Today, it is suggested that "*while financial tables are created with the cost* *management method, information about the current values can be attached to the financial tables*," which is in reality a suggestion that was put forward by the SEC in 1936 (Yılmaz, 2009: 6). Financial reports containing two valuation principles can be issued to ensure decision makers are more clearly, transparently and accurately informed. In this way, companies may still be attached to the fundamental accounting concepts and principles, and may improve the quality of the information they produce (without the need for a possible crisis).

Transparency Problem and Auditing Weakness

UNTACD made the following statement in its report issued in March 1999: "*Excessively indebted companies, the strong external borrowing tendency of the private sector, deficiencies in transparency and accountability all account for the failure of financial institutions and companies in the Far East ... The shortcomings in financial statements have an important role here. The weaknesses in the rules related to financial reporting indirectly contribute to the internal audit defects and faulty or inappropriate risk management at banks or companies*," and this is true also for the 2008 crisis (Aysan, 2009). It has been mentioned that the current credit crunch in the United States resulted from "*the asset balloon which was inflated and then burst, big transparency problems about complicated bills of exchange and their derivatives that do not dilute the risk but increase the systematic risk caused by excessive borrowing, in addition to the audit structure which has not been able to ensure stability*" (Spence, 2008: 26; Daştan, 2009: 60). If especially independent audit mechanisms confirm that the financial reports issued by enterprises are not misleading, such reports will definitely become more reliable from the perspective of their users. The intention with an audit is generally to help detect and report a given company's compliance with generally accepted accounting concepts and principles, accounting systems, methods and standards and laws related to the capital markets, trade and tax, which all come under accounting legislation. Therefore, the reliability of audited financial reports is accepted to be relatively higher than that those which are not audited, although reliability, when auditing financial accounts, may be misleading. For example, investors may be less skeptical of financial reports if they believe they have already been audited, and such reports are more likely to misguide investors in the event of a weakness in auditing. As a matter of fact, many large companies that went bankrupt had undergone financial audits, and had been given positive reports; however these companies showed their true colors after it was understood that their financial reports were full of mistakes and tricks, and they found a way to make the reports look legal. There are numerous examples of this *(see. Annex: Accounting- Auditing Scandals).*

However, *"bad decisions made by the banks and auditing mistakes underlie the problems about the crisis. The incentive systems applicable to top management are defective. The problem depends on the non-transparent share options that make it possible to swell the reports and pave the way for a bad accounting system"* (Stiglitz, 2008: 9; Daştan, 2009: 61). Existing accounting systems have been unable to develop successful methods of measurement for hedge accounting, and the accounting of derivative products is still problematic. Complicated as they are, financial assets are not properly priced or valued, and excessive valuations cannot be prevented; and for this reason the relevant parties are mere spectators in the occurrence of financial balloons or foams, and just stand back and watch them burst, so to say. On the other hand, hidden losses and swollen profits match the benefits of the management team, in that managers continue to receive their incentives and premiums on the declared profits, even if the company is going to the wall. The managers of 25 companies whose share prices decreased by 75% between January 1999 and May 2002 were paid wages, premiums and other fees that amounted to 23 billion USD, however this only became clear after the companies became insolvent (Fortune 2002 September, in Aysan 2009).

Some say financial crises result from non-transparent accounting practices and financial reports, whereas others think that the steps taken to ensure transparency produce unnecessary information, and excessive information flow to the market increases the perception of risk that in turn causes the market to react more violently, leading to volatility (Sak, 2008).

IV. EVALUATION AND CONCLUSION

When asked "*What is life?*" Einstein replied, "*Life is a total of the decisions one makes*," just as the global credit crunch of today's world is the consequence of yesterday's unsound decisions. Commenting on the crisis, Joseph Stiglitz, 2001 Nobel Prize winner and former Chief Economist at the World Bank, says "*bad decisions made by the banks and auditing mistakes underlie the problems".* It should be accepted that the past decisions of countries, enterprises and individuals have all contributed to the current crisis. In fact, this "*is a depressive mode that can also be called as a set of commercial mistakes*" as it is "*a macroeconomic depression that occurred in a certain period as a result of insufficient or wrong managerial preferences*" (Apak, 2009: 6). In one of the traditional round table meetings of MUFAD (the Association of Accounting and Finance Academicians), while discussing the "Global Credit Crunch and Turkish Economy," Ertuna drew an analogy, *"the same sheep was flayed three times*". In that same meeting it was also mentioned that the financial crisis had been caused by 6^{th}-7^{th} degree asset securitization, which can be considered as a fifth wheel, and while it should have been confined to the financial sector, it unfortunately spread to the real sector (MUFAD, 2009: 203–215). The similarities between the most recent crisis and previous ones give us important clues regarding past mistakes (Aysan, 2009: 28), which are namely:

- Swollen assets and profits not being taken seriously,
- Swollen assets and values not being audited and approved,
- Increases in pyramidization among enterprise groups,
- Unavoidable sovereignty of private companies,
- Real values being beaten by the values of financial assets,
- Dramatic increases in off-balance sheet values and derivative products,
- Abundances of cash and credit, and

- Low interest limits and flexible borrowing rules.

Akerlof and Romer (1993) argue that deficient accounting systems, flexible legal regulations and low fines will lead to bankruptcy for profit. Given the below-mentioned hints, can the current global credit crunch be called a crisis of accounting or auditing? Although there are people who defend this opinion and argument, the current crisis cannot be blamed only on accounting and auditing-based problems, however it should be understood that the gaps, defects and weaknesses in accounting and auditing, as well as collusive transactions, certainly played an important role in the emergence of the crisis. Any breach of universal accounting principles, which can be regarded as the constitution of accounting, cannot go unnoticed. The relationship between accounting and the crisis can be summarized as follows:

- Deviation from the concepts of social responsibility, personality, continuity of enterprise, periodicity, monetary unit standard, cost principle, objectivity, full disclosure, prudence, materiality and regularity,
- Flexibility in prudence and exaggerations of fair value accounting, which is not conservative,
- Having recourse to creative accounting practices, abusing flexibilities and gaps in accounting rules in order to show the enterprises differently to how they really are,
- Issuing misleading financial reports and having them audited by independent audit companies,
- Non-transparent accounting practices and off-balance sheet applications, particularly related to derivative products.

The above-mentioned points should be considered among the many reasons for this crisis. If the crisis has resulted from existing accounting and auditing systems and practices, as it has been suggested, then the solution should also be sought in the accounting and auditing system, and in this respect, accounting and auditing should also be held responsible for this crisis. But whether they are held responsible or not, accounting and auditing have to be involved in the initiatives to reverse the crisis and protect the benefits of society as a whole, thus fulfilling their core mission. Ideally, accounting and auditing systems have to be restructured in such a way that they can prevent crises, and such restructuring, though not so easy, can make warning systems truly functional before or during crises. Failure to do this will lead to an inevitable discussion on the *raison d'être* of accounting and auditing systems.

As the world has been moving towards a market economy for the past 50 years, the globalization concept has come into being, and this has accelerated the development of information-based economic structures. Accordingly, the need for information has increased significantly and information-based professions have gained importance. In this context, the importance of the accounting and auditing professions in the structuring and conduct of accounting practices has become obvious (Selimoğlu, 2008: 31). The responsibility of accounting and auditing professionals both before and during crises is to ensure that society is reliably informed, as one of the main reasons for financial crises is that publicly-shared information does not necessarily reflect the truth. In order to prevent financial scandals before they turn into economic crises, accounting and auditing professionals can (Aysan, 2009: 28):

- examine swollen financials better, prevent the recognition of unrealized gains,
- improve the options and definitions of valuation methods,
- prevent off-the record assets and liabilities,
- help companies improve their internal audit and risk management,
- develop accounting standards to prevent swollen assets and profits,
- work harder to revise and standardize accounting standards, and
- ensure that the personal rights granted and amounts paid to managers are justified.

Galbraith is of the opinion that the prevention of crises through audits can only be achieved by raising awareness (Galbraith, 1994, in Ertuna 2009: 9). By "Awareness," it is likely Galbraith is referring to ethics, in that financial crises certainly result from unethical behavior, even if just a little. Commenting on the global credit crunch, Dutch Prime Minister Jan Peter Balkenende states, "*This is essentially an ethical crisis resulting from an unhealthy obsession with money, selfish trade and greed*".

It general, non-public (small) companies show their assets and profits less than they really are in order to lower their tax base, whereas publicly-listed (big) companies swell their assets and announce higher profits than the truth to gain access to more and more sources of financing. It is at this point that accounting and auditing are subject to abuse. While one party shows its assets as expenses, the other shows its expenses as assets. In fact, small-scale enterprises are in trouble with the State. Big enterprises, on the other hand, are in trouble with people; and it is because of these companies that appear to be more successful than they really are that the State and the public usually end up suffering. Crises break out when the loss is clearly felt and can no longer be tolerated, and society has to foot the bill. For this reason, economic and financial crises can at the same time be considered ethical crises.

LAST WORD: "EITHER EXIST AS YOU ARE OR BE AS YOU LOOK" …" (Rumi).

ANNEX[1]: Accounting- Audit Scandals

Case of Vari-L

Charles Springer, co-auditor of auditing and consultancy company Haugen, Springer Co, PC, based in Colorado, audited the 1997 financial tables of Vari-L, but failed to notice that the income was being dishonestly recognized, that the labor costs and operating expenses were listed under assets, that the stocks were valued at more than their worth and that fake invoices were being issued for unrealized sales. In this way, the company appeared to be profitable, although it had suffered pre-tax losses between 1996 and 2000. Their reports on Vari-L had included positive auditing notes for the years 1996, 1997, 1998, 1999 and the first quarter of 2000.

Case of Waste Management

Although Arthur Andersen noticed errors in the financial accounts of Waste Management, the company issued a positive auditing report, and Andersen's working notes referred to false declarations corresponding to 12% of the total income as "trivial". The SEC stated that Andersen may have issued positive reports so as to protect and retain a very valuable client.

Case of Sunbeam

This case involves a comprehensive manipulation of the financial accounts of Sunbeam, based in Florida. There were two sides to this manipulation: a) Income being detected to be against procedures, and b) the creation of funds. The funds in question were created to finance a restructuring after a change in management, however they were intentionally swollen. In the following terms, operating expenses were not deducted from the income of the current period, but instead from these funds. In other words, the income figure remained the same. Another problem related to income recognition was that invoices were being issued for goods which in reality had not been sold, and so sales income appeared to be on the increase. Accordingly, Sunbeam recorded an income of 189 million USD in its financial accounts at the end of 1997, however in truth 32.8% of this (62 million USD) was based on false transactions. The manipulation, which had been made by the General Manager and the Senior Finance Manager, caused the company's share prices to increase from 12 USD to 52 USD in the 1996–1998 period. The SEC report states that the auditor at the time had asked for a correction of 16% in the income-related figures, although s/he had identified other problematic transactions. This fraudulent accounting would seriously affect the share prices and account owners, however the auditor did not demand all the discrepancies be corrected, nor did s/he note them in the report. The auditor found only 16% of the false declarations problematic and asked for correction to that figure, after which s/he issued a positive report. In

[1] Quoted from Selimoğlu 2008: 164–166.

fact, the auditor should have taken into consideration the 32.8% of false declarations and issued a negative report.

Case of Cendant

What happened at Cendant, based in New York, revealed several tricks of the trade, such as the manipulation of funds, income recognition against procedures and understating of expenses. The Cendant company management made a surreptitious plan in order to prevent the auditor from unraveling their false accounting. Cendant hid falsely-stated funds (provisions) in the accounts of its subsidiaries, which it knew would not be subjected to a detailed audit. The trick fooled the auditors Ernst & Young, and Cendant was able to swell its remaining cash balance, which stood at 49 million USD, to 149 million USD. It is hard to believe that such accounting fraud could be missed by an auditor when s/he sees that there is no 100 billion USD banking operation in the year-end account statement. However, as the auditors had at that time not changed their opinion of Cendant, it is understood that they did not notice this "problem". A member of staff at Ernst & Young who took part in the audit explained their failure to detect the problem as follows, "*We never thought that the guys at Cendant would do such sorts of things*". This case resulted from the lack of a professional perspective and diligence, as well as a violation of important principles like skepticism.

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