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Global financial crisis: The challenge to accounting research

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A B S T R A C T

Accounting practices are deeply implicated in the current financial crisis and in proposals for recapitalizing financial institutions and restoring stability to the global financial system. This essay discusses the methodological and theoretical gaps in accounting research that explain our failure to anticipate the crisis and limit our ability to analyze and respond to it.

Introduction

While it has become commonplace to blame bankers and their bonuses for the current global financial crisis, as the economic ruin deepens and spreads more fundamental questions will undoubtedly be asked about our economic system and the institutions upon which it is founded. The academic community is one such institution. Why did neoclassical economic thought become unquestioned doctrine in so much of our academic discourse? How did business and economics departments come to be champions of market dogma, rather than centers for intellectual debate and social critique? In the years preceding the near collapse of the US financial system, why did the looming catastrophe, inherent in a highly financialized economy that was fuelled by irresponsible lending practices, financial engineering, bogus bond ratings, opaque financial instruments, and the growth of a systemically dangerous shadow banking system, escape the attention and critique of academic researchers?

The magnitude of this financial and economic crisis calls for a fundamental reassessment of all areas of business and economic scholarship, including accounting research. This essay examines the reasons accounting research largely failed to anticipate the crisis that was ballooning in the world of accounting practice. The aim of this self critique is to identify the gaps in our research methodologies and theories in order to better position ourselves to interpret the crisis and understand accounting's role in ongoing attempts to find a resolution to it. Two reasons for accounting academics' failure to anticipate the crisis are discussed. The first is methodological, namely the persistent gap between the world of academic research and the world of "accounting in action" (Hopwood, 1978). The second is theoretical, namely our failure to understand the linkages between micro accounting and regulatory technologies, and the macroeconomic and political environment in which accounting operates. The essay concludes with suggestions for a research agenda aimed at understanding accounting's role in the financial crisis.

Bridging the gap between academic research and the world of "accounting in action"

The world of accounting practice is implicated in the current financial crisis in a number of ways. The most obvious is through financial reporting requirements governing asset valuation and off-balance sheet entities (Ryan, 2008). The importance of these seemingly mundane accounting rules is underscored by the fact that the solvency and survival of our major financial institutions now turns on how accountants value bank assets and the extent to which auditors require firms to consolidate off-balance sheet entities. Fair value accounting rules, which require companies to write-down financial assets to reflect plunging market values, have been generating intense controversy. Critics charge that fair value accounting first contributed to excessive credit expansion and then exacerbated the downturn by encouraging pro-cyclical risk taking (Boyer, 2007). Opponents of fair value, including many within the banking industry, are exerting pressure on accounting regulators to modify valuation rules, while advocates

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remain vehement in defending the need for fair value accounting in order to reveal the full extent of bank losses.

Although less in the spotlight than the fair value debate, financial reporting rules governing off-balance sheet structured investment vehicles (SIVs), including rules on special purpose entities (SPEs), qualified special purpose entities (QSPEs), and variable interest entities are equally, if not more, significant. In the 1980s, US accounting standards setters began allowing banks to move securitized loans and related debts off their balance sheets and onto the books of these off-balance sheet entities (Turner, 2008). This obviously flawed rule which enabled the creation of the shadow banking system has been modified several times since the 1980s,[1] but never satisfactorily. The practice of using structured investment vehicles to move banking operations off-balance sheets in order to evade accounting rules and regulatory capital standards, together with the potential impact on capital adequacy ratios of forcing banks to consolidate off-balance sheet vehicles remains a crucial issue facing accounting and regulatory authorities (Group of Thirty, 2009, pp. 48–49).

Financial reporting is not the only way accounting is implicated in the crisis; the major accounting firms in the US and Europe were also directly involved in the process of securitization and structured finance. In their capacity as advisors to investment banking clients, the major firms performed due diligence work, offered accounting and tax advice on off-balance sheet vehicles, and assisted with the securitization of trillions of dollars of mortgage back securities (MBS) and collateralized debt obligations (CDOs). Although an evaluation of the extent of the accounting firms' role in the making of the crisis is beyond the scope of this essay, a preliminary review of the firms' marketing literature indicates that their advisory service divisions were active participants in the securitization industry in the years leading up to the crisis. The following excerpts are illustrative of securitization services offered by all of the Big Four international accounting firms.

- Since 1985, Deloitte & Touche USA, LLP professionals have added insight, consistency and value to more than 14,000 securitized offerings with an aggregated principal of more than $5 trillion... Serving leading players in the MBS, ABS, CDO and CMBS markets, domestic and global, we offer state-of-the-art products and expert services in financial modeling, analytics, technology, operations, due diligence, accounting and tax.
- In the past year, the PwC's and the Structured Finance Group (SFG) have been involved in securitization transactions totaling billions of dollars. Structured Finance Group professionals combine a high-level of technical expertise to provide a wide range of securitization services, such as: deal structuring, asset valuation, due diligence, modeling, operational consulting, tax and accounting analysis, tax reporting and technology development, implementation and maintenance (American Securitization Forum, 2006).

Accounting research lagged behind this burgeoning world of accounting practice. While accounting practitioners were involved in the securitization schemes that ultimately led to the crisis, accounting scholars were largely unaware of their activities or the troubles brewing in the credit markets and shadow banking system. The premier academic accounting journals did not address the dangers of structured investments, securitization, and off-balance sheet entities until 2008 when the credit crisis was in full swing. The leading journals published more articles on these topics in 2008 alone then in the ten preceding years (1998–2007) combined. While there were a number of research studies on fair value accounting published in the mainstream accounting literature in the mid 1990s, they tended to assess fair value accounting narrowly in terms of whether it provided incremental information to capital markets rather than evaluating its macroeconomic consequences.[2] With few exceptions, academic accounting research generally failed to anticipate the crisis, or mount a substantive critique of accounting's contribution to systemic financial instability and/or accounting firms' involvement in securitization and structured finance.

Some will argue that the shadow banking system is too opaque for accounting researchers to penetrate since empirical data on off-balance sheet entities, hedge fund activities, credit default swaps and other privately traded derivatives are unavailable. This view suggests that our research agendas must necessarily be limited and ultimately shaped by the availability of quantitative databases. The alternative to this unacceptable proposition is to begin to take seriously the methodological problem of finding ways to engage the world of accounting practice. Arguably, some of the most socially important aspects of accounting practice are those where the difficulty of obtaining data has, with few exceptions, produced a lacuna in academic research. These include issues such as tax evasion, money laundering, transfer pricing, off-balance sheet financial activities, and the politics of accounting standard setting, to name but a few.[3] The task of bridging the gap between accounting research and this world of accounting practice is extremely difficult, but nonetheless essential. We have seen some progress in the field of managerial accounting where strides have been made towards understanding "accounting in action" (Hopwood, 1983) within organizations through the use of case study and ethnographic research methodologies. The need for financial accounting research to reduce its dependence on quantitative databases and develop the methodological tools, institutional knowledge, and links to practice needed to bridge the gap between academic research and the world of "accounting in action" is one of the most significant challenges posed by the current crisis to accounting research.

[1] See SFAS No. 125, SFAS No. 140, and FIN 46R.

[2] The critical accounting literature, by contrast, published several critiques of fair value accounting for financial instruments. For example, see Hernández (2003), Ishikawa (2005) and Young (1996).

[3] Exceptions include Mitchell, Sikka, and Willmott (1998) on the role of accountancy firms in money laundering, and related work on tax avoidance, off-shore financial centers, and transfer pricing. For example, see Sikka and Hampton (2005), Sikka (2008) and Sikka et al. (2009).