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## AN ACCOUNTING PERSPECTIVE ON A CRISIS PERPETUATED THROUGH THE CAPITAL MARKET

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### **Abstract:**

*Our paper analyzes the current financial crisis starting with some recent developments and reactions in the field of accounting. We find that involved parties within the financial system naturally look for a “scapegoat” instead of dealing with reality. Moreover, they try to avoid regulations that would reflect their current financial position and performance. Meanwhile, what reality reveals us is that we are dealing with a crisis of value, or better said valuation, framed by significant changes of paradigms. Starting with thoughts and reactions within trade literature and financial environment, we analyze some mechanisms of credit derivatives that propagated the crisis within the global financial system. Finally, we prove our point in defending fair value accounting and identify key aspects that allow future improvements. The need for informational transparency is emphasized through the whole paper.*

**Keywords:** Financial crisis, fair value, derivatives, mortgages, informational transparency, capital markets.

**JEL Classification:** A12, G01, M40, M41

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## **Introduction**

One way of looking at the current financial crisis is that it represents the first great recession affecting developed countries since the reorientation of the value creation system from goods' production towards creating intangibles. If we are to analyze the situation considering an economic theory's perspective, this could be Schumpeter's theory<sup>16</sup>, the current "destructive creativity", as some see it, having to determine the establishment of new limits within the value creation process. We are now being confronted with a certain state of facts, within which those economies that relied on intangibles as a competitive advantage, in times when what is considered to represent value is not guaranteed through any form of tangible assets or products, are faced with the collapse of financial networks, and even evaporation of the fictitious capital that allowed the development of the new capitalism. What our paper accomplishes is to analyze the reactions of those involved within the accounting information market under such difficult circumstances, what is the truth as revealed by analyzing the facts, and some reactions within trade literature. All these represent in our opinion chain reactions to a new lesson that the capital market and its mechanisms seems to have persisted on making us realize.

### **Methodological approach**

Considering the purpose of our paper, that is to give an accounting perspective on the current financial crisis, the starting point of our analysis is naturally the accounting information market. It is there that we found many voices considering fair value accounting to be significantly responsible for the current state of facts. Furthermore, the structure of the paper is implicit. We have first considered some main opinions within trade literature on fair value in connection to the current situation, and then proceeded to performing a closer analysis of the situation. This required presentation of precise attitudes and requirements that appeared in the field of accounting under the pressure of such stressful circumstances. Afterwards, we performed an incursion within the credit derivatives market where the roots of the current financial crisis can easily be identified. Following these findings, we see how the crisis was then perpetuated worldwide. This approach allows us to see the big picture while emphasizing accounting issues.

### **Some thoughts within trade literature**

As mentioned above, what we have tried to accomplish through the literature review section is get some insights into what current researches state concerning the concept of fair value and its usefulness during financial crisis that affect capital markets around the world. By doing so we show that the role of fair value accounting

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<sup>16</sup> Economic theory that took the name of the Austrian economist of the XX<sup>th</sup> century, Joseph Schumpeter, showing, unlike other modern theories on development, that this could be explained through innovation and entrepreneurial spirit.

within this process is just to capture the changes appeared in the market prices. Even though the utilization of inadequate assumptions for the initial valuation of the mortgages has surely contributed to mastering the current problems, this represents finally an error of valuation and not a problem caused by the application of fair value accounting *per se*. That which fair value actually does is to bring the true dimension of these errors of valuation, in the eyes of the investors, in a short interval of time (Wallace, 2008). The main difference between recognizing an asset at its fair value or at its depreciated cost is represented by the recognition of some unrealized losses or gains in the alternative of fair value. However, these losses or gains represent in fact changes in the value of future generated incomes by the considered asset. As a following, coming back to the current financial crisis, the losses that banks are ought to confess under the option of fair value, captivates in fact the true impact (upon the present and future incomes) at considering a higher degree of underwriting the mortgage credits that had been already given.

Even if this impact is quite significant, what we must acknowledge is that it only represents a repercussion of a vicious circle previously formed. Concerning the decrease in the investor's interest for structured derivatives linked to mortgage credits, it is true that the drawback from these products is nourished by their fair value measurement, but we consider this the normal reaction that investors should have had from the beginning towards these products of financial engineering. In other words, current fair value measurement does nothing but imposes banks to recognize the existence of some real problems created earlier, and making it possible to take actions, since they will not disappear by themselves irrespective to the postponement period. Moreover, when these problems are not recognized, the mechanism could continue, enrolling other investors as naives as the previous ones (Matis and Bonaci, 2009).

Despite all critics brought to the concept of fair value, especially during such problematic times, those voices that are arguing for the restriction of its application remain unconvincing for at least three reasons. They don't bring any viable alternative, while ignoring the negative impact that should result from the loss of some information that are presently offered within financial statements, and also altering the distinction between accounting and prudential concerns, which have in fact different objectives and they should be separated with great attention (Veron, 2008). The opponents of fair value loose this dispute from the very start, because they do not manage to materialize their arguments through actual solutions, or in other terms, they are missing a "counter-offer". If it is easy to identify and underline fair value accounting's deficiencies, it is not so easy to find a better alternative that brings together the characteristics of relevance, credibility, comparability and intelligibility that a large consensus and a series of principles attributes to the actual standards in the domain.

Another important aspect emphasized within trade literature is that such a severe crisis like the current one is not, and could not, be the fault of any one set of parties, but involved the entire economic system failing to appreciate the risks of the

rapid growth in risk-layered subprime mortgages, the inevitable reversal of home price appreciation, and unprecedented global market liquidity (Ryan, 2008). It was all these factors that brought out the undisciplined behaviors in lenders, borrowers, and investors, making them ignore what common sense would have pointed, and that is not to forget about 'fair valuing' the real risk. As Ryan (2008) points out, "economic policy, bank regulation, corporate governance, financial reporting, common sense, fear of debt and bankruptcy, and all of our other protective mechanisms were insufficient to curb these behaviors". The author also finds the explanation for this type of irrational behavior displayed by investors within Keynes (1936) description of behavior underlying upswings in economic cycles:

Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than mathematical expectations, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as the result of animal spirits—a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities (Keynes, 1936).

Fair value accounting or any other valuation method has no chance in eliminating such behaviors (Ryan, 2008). Where fair value plays an essential role, is in informing relatively rational and knowledgeable market participants on an ongoing basis, and providing a common set of information upon which market participants can recalibrate their valuations and risk assessments when the economic cycle turns. This recalibration is essential to occur as quickly and efficiently as possible, as it should nowadays. Ryan (2008), as many others mentioned before, also notes that any form of historical cost accounting would drag out these recalibrations over considerably longer period, likely worsening the ultimate economic cost of the crisis.

Matis and Bonaci (2009) empirically dimension various opinions on fair value within recent trade literature by analyzing all papers comprised within the 2005-2009 issues of the 16 international journals in the field of accounting belonging to the Thomson Reuters Master Journal List. They document the fact that in the field of financial instruments most of the authors sustain fair value accounting, especially through results obtained within empirical studies. Moreover, they find that even those studies who argue against fair value within empirical studies, explain their position by some of the concept's shortcomings in cases when objective data coming from active markets are not available. Another important finding of their study is that opinions within the analyzed trade literature have not been significantly affected after the crisis became noticed, the 'pro studies' recording a constant number through the 2005-2009 period, while 'against studies' were even fewer after year 2007.

We can conclude upon analyzing opinions within trade literature that identify serious issues related to practical aspects of fair value accounting, the main problem being actually related to the fact that it affects the income statement through unrealized gains and losses,

by ironically going back to what Solomons (1961) was predicting concerning to the importance carried out by profit measurement, that might record a descending evolution:

Each one of us undoubtedly thinks of the future in a different manner. However, my own suspicion is that, as for where the history of accounting is concerned, the next 25 years may afterwards be seen as the twilight of results' measurement (Solomons, 1961, p. 383).

We also join Georgene B. Palacky<sup>17</sup>'s opinion, who as a representative of the investors and their interests stated:

I wish I could see people giving up talking about fair value as being the problem within this situation, and focusing on fundamental problems: lack of market discipline, underwriting process and practices within the subprime sector, and the rewards obtained by actually challenging risk ... it is too much noise for something that does not represent the real problem. It is just a manner of distracting attention from actually dealing with real issues (Georgene B. Palacky, director of CFAI).

After clearly pointing that trade literature actually supports fair value accounting even thorough such difficult times, we must now go to those aspects that started our research. That is some unjustified reactions among parties involved in the credit derivatives market that will actually be proven self interested when blaming accounting and not taking responsibility for their own implication.

### **First reaction - naturally identifying a “scapegoat”**

As stated before, the concept of fair value and its merits have always determined strong debates, especially in the field of financial instruments. Still, the current financial crisis has clearly generated an intensification of these debates. It seems that combining the accounting fair value principle and the rules on banks capital adequacy, also having strong connections with accounting, might have had a pro cyclical effect. Some banks and insurance companies' managers reacted by blaming accounting standards for the actual state of facts. This is easy to understand since it is much easier to blame accounting standards rather than rules within the banking system, considering that they are still under close observance of bank supervisors. An important and significant aspect we consider the fact that the participants at the G20 summit did not blame the principle of fair value in November 15, 2008. The public declaration following it did not refer to fair value, although accounting authorities were asked to ... work on improving the guidance for securities' valuation, considering some complex, illiquid products, especially during difficult periods (Rérôle, 2008).

All debates on fair value measurement intensified during recent periods, big financial institutions having to recognize within their financial statements losses of more than 150 billion \$, mostly under the use of market values (Beller *et al.*, 2009).

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<sup>17</sup> Director of the Group for Financial Reporting Policies within the Chartered Financial Analyst Institute – CFAI.

Meanwhile, SEC<sup>18</sup> is investigating the possibility of use, by some entities under research, of different market values for the same securities. From this perspective, nobody can deny the fact that the use of fair values involves some problems, especially in extremely difficult periods from the market's point of view. For all that, the defenders of fair value bring as an argument, its capacity to ensure a certain connection to reality, associated with another aspect of reality, namely own shortcomings of alternatives for the market value. We refer here to the fact that, neither the reflection value of some elements only in their costs, under the historical cost principle, would not provide investors a better image concerning the problems that financial institutions are now confronting (Matis and Bonaci, 2009, p. 126).

Nevertheless, since the end of September and beginning of October 2008, Wall Street Journal published a series of articles that described how the banking industry is revolted against fair value accounting, bringing a series of criticisms, mainly because these would impose them to diminish their assets' value within the balance sheet, often going lower than values showed on the market. It seems that the financial institutions militate for an elimination of the fair value, seen as a partial solution for the banking industry nuisances. Wall Street Journal presented a letter of the American Bankers Association – ABA, asking SEC to recognize that fair value has no significance within illiquid markets.

Meanwhile, remarkable personalities belonging the banking industry (such as Martin Sullivan, the former executive director of AIG and Henri de Castries, executive director of AXA) considered fair value and the use of market based valuations on a large scale to be a major factor of the current financial crisis (Hughes and Tett, 2008). As a reaction to these statements, the European Commissioner Charlie McCreevy also expressed, in last year's spring, his concern regarding the impact of market based valuations in those cases when markets become generally illiquid and irrational (McCreevy, 2008).

The only way we can argue against these unjustified reactions is by analyzing the credit derivatives market and showing where things really went wrong and which were those factors that determined the current state of facts.

### **Looking for the truth within the mechanisms of credit derivatives**

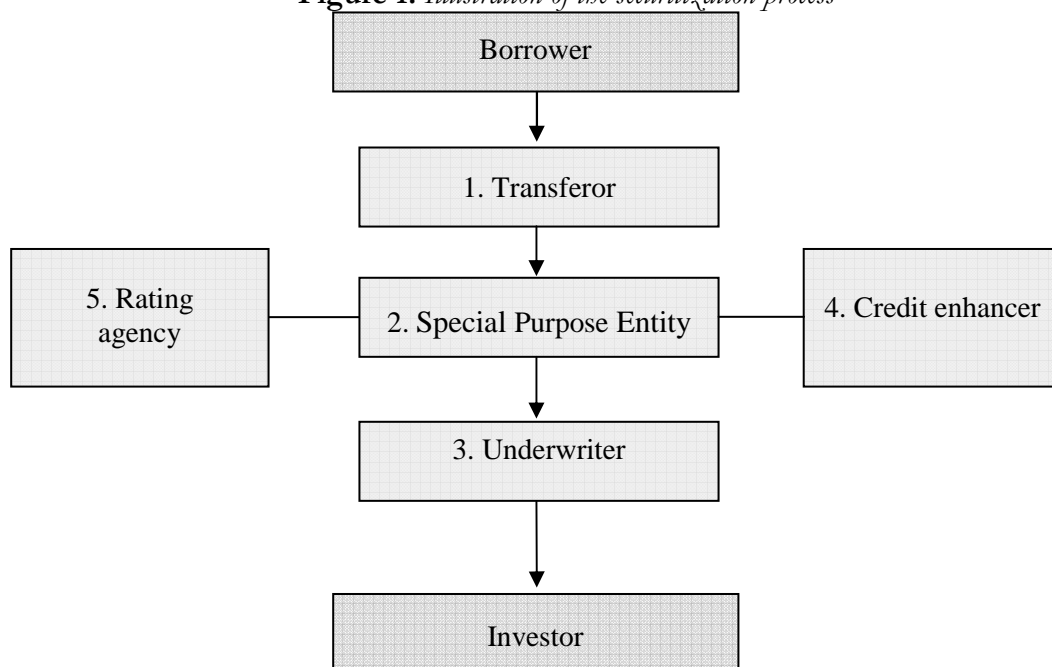
Determining the degree to which the current financial crisis can be connected to fair value measurement can only be judged after a short introspection within those, mechanisms, which in time, have created an extremely problematic situation raised within capital markets around the world. That is why we have to start with the origin of the problems appeared on credit markets, and more specific, mortgage backed securities and different financial instruments, more or less complex, further structured from them. We will therefore refer to the technique of securitization, which consists in transforming the existent credits in titles on the capital market.

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<sup>18</sup> *Securities and Exchange Commission.*

Presented from an accounting point of view, securitization represents a financial technique through which a financial institution or a company (the transferor) creates a separately legal system (the already well-known Special Purpose Entity - SPE) to which it transfers financial assets, such as loans and receivables (towards a debtor). The following figure presents all elements that need to be considered from an accounting perspective:

**Figure 1.** *Illustration of the securitization process*



Source: Kendall (1998) quoted by Niu (2007) and Abd Allah (2009)

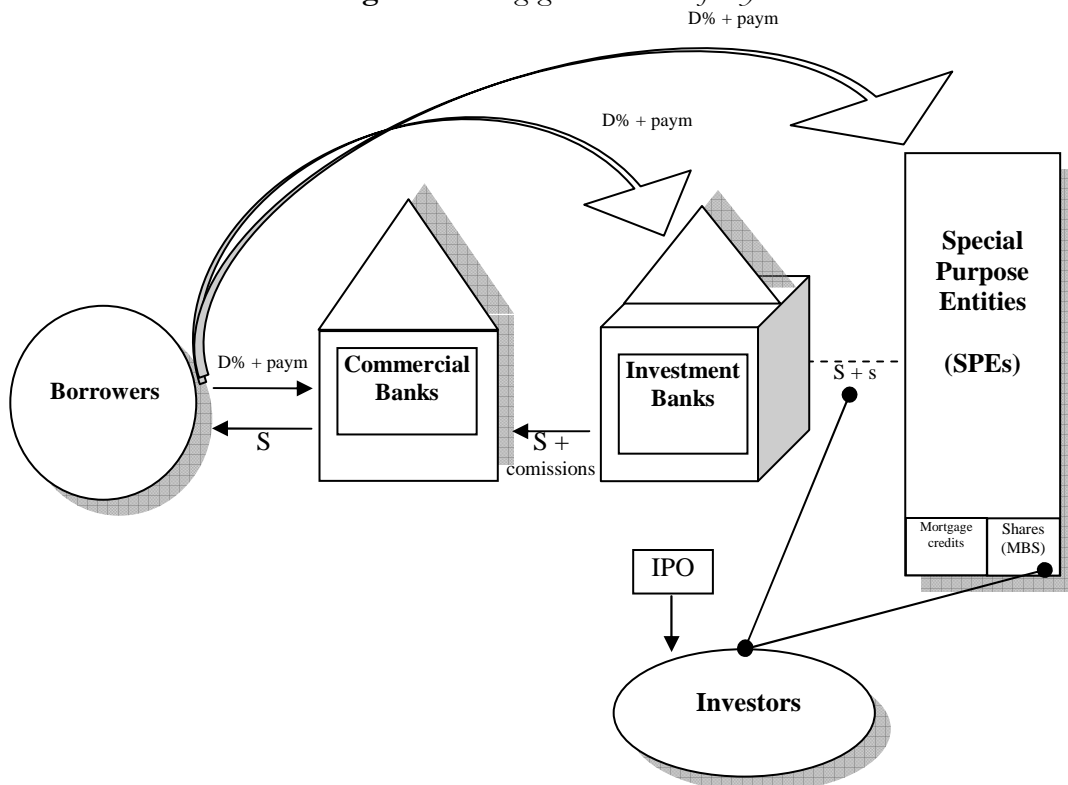
The Special Purpose Entity is the one issuing securities that are then offered to investors, being launched on the market and given prices by the underwriter, usually an investment bank. The Special Purpose Entity will transfer the money paid by investors who purchase the structured derivatives to the transferor (who transferred the financial assets). The process often involves a credit enhancer that is supposed to attract investors and a rating agency that should reduce risks assumed by investors from their point of view.

Abd Allah (2009) quoted this year some previous studies whose statements now have a different dimension and attract special attention, after the lesson has been personally delivered to us:

While the market for securitization is growing and getting more popularity for the collective benefits obtained by the participating parties in the process (Jobst, 2006), the technique should devote much caution so as not to lead to financial crises because of its complexity (Engdahl, 2008).

We will furthermore detail the securitization process in order to better analyze it. Special Purpose Entities' assets are therefore formed by receivables, materialized in mortgage credits overtaken by the investment banks from the commercial banks. These new SPEs will surely issue their own shares that will be sold on the market, at as higher prices as possible, surely higher than the value of the corresponding assets (materialized in mortgage credits). It is these shares issued by SPEs that are known as Mortgage Backed Securities (MBS). For a long period of time, this sell was possible due to the fact that investors' appetite was maintained through the increase in the support assets' prices of those certain securities, especially in real estates that represented the mortgages for the credits. SPEs' shares were sold on the capital market through Initial Public Offerings. Through such a sale, investment banks recovered more than they have paid to commercial banks in order to overtake the mortgage credits, this way obtaining a profit. Meanwhile, the mortgage credits, as assets (receivables) of the new opened SPEs became a receivable held in fact by those investors who purchased shares. The next figure makes a synthesis of the role of the investment banks:

**Figure 2.** *Mortgage credits' transfer system*



Source: Matis and Bonaci (2009, p. 142)



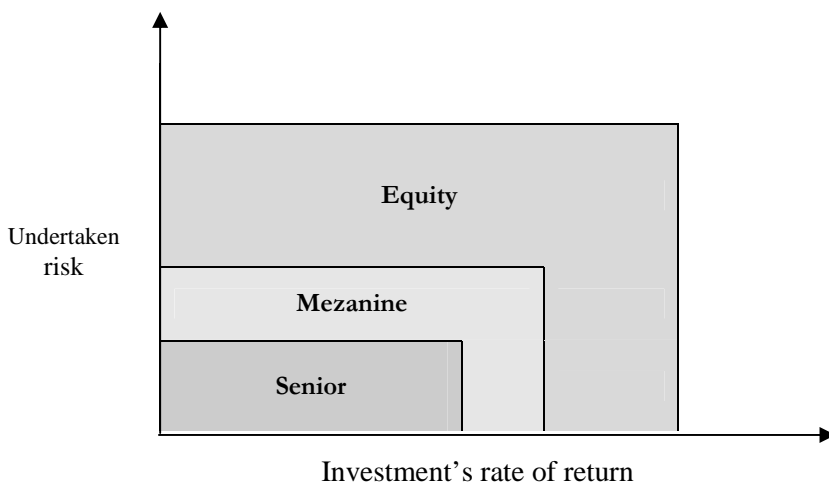
Those shares issued by these SPEs are well known within trade literature as Mortgage Backed Securities, representing in fact securities backed up by mortgage receivables. Furthermore, we will refer to them as MBS. They represent securities that can be transitioned by the entity, offers the entity the right of encashment of rates and interests, encashment guaranteed through mortgage. In this situation, if one of the mortgage credits' beneficiary could not face up the payments, the entity has the right to sell the mortgage property in order to recover the investment. It is shown in this way how the intermediary chain in mortgage credits gets longer and longer, each link following its own profits through the creation of its own joint point, when, in fact, the main connection is between the beneficiaries of the loan (borrowers) and the ones who actually finances the loan, the investors that buy securities like MBS. Considering the investors' point of view, this approach is different from simply granting a loan because by owning the MBS, the investors have the right to receive the rates and interest the beneficiaries owe, but in the same time they guard a low share resulting from the fact that this securities can be sold according to the circumstances (Matis and Bonaci, 2009). In other words, the securities assure the investors a certain liquidity regarding the market within which they are transitioned. Still, a real accounting issue is valuating these MBS, this being influenced by a series of factors that have to be taken into consideration, such as the probability that the mortgage credit's beneficiary could not make the payment on time, that they will pay back the credits in advance, the evolution of the interest on short term, all of these needing complex valuations based on models, more ore less well used.

It is also a well-known fact that investors on the capital market have different profiles. Therefore we must consider investors that will accept a lower income if they can benefit of a certain safety for their investment, but also investors that can be attracted only by the possibility of obtaining a high revenue, proportional with their expectations and assumed risks. It is also possible that in the considered situation of credit derivatives, some of the investors will have certain boundaries related to the perceived risk being imposed by law, as for example mutual funds. The way of answering the interests of as many as possible investors is through the creation of an instrument derived from the securities issued by the special purpose entities (MBS). In fact, this is also the role of derivatives, obtained by the division and structuring of an asset in such way that risk dispersion is made through an asset derived from the original one.

We will maintain the same circumstances previously mentioned in order to explain the mechanism for developing such a derivative, with the only difference that, the SPE will not emit MBS having the same characteristics, but, first, it will structure these securities in three big categories or trenches. These three trenches are known within trade literature as Senior, Mezanine and Equity. That which differentiates the investors in the three groups is the undertaken risk and the gained reward or the investment's rate of return, combined as shown within the next figure. Moreover, the created structure has the form of Collateralized Debt Obligations (CDO), more precisely Mortgage Backed Collateralized Debt Obligations. Such a

derived structure could be accomplished with any kind of loan guaranteed by an asset.

**Figure 3.** *CDOs structure*



Source: Matis and Bonaci (2009, p. 144)

An even more complicated derivative, with major contributions to the current financial crisis, allowing easy and quick transfer of mortgage credits, and therefore encouraging banks to assume bigger risks and completely forget about prudence, is the Credit Default Swap (CDS), representing the derivative financial instrument with the fastest ascension in the financial sector.

For banks, transferring those risks associated with their financial assets has the ability to generate multiple favorable effects, such as better risk management, establishing some differentiated capital requirements, as well as improving their credit ranking. Moreover, improving their credit ranking also involves lower financing costs because the bank's risk profile is one of the considered elements when calculating the interest rate for their financing. Meanwhile, credit rating represents an evaluation of the bank's solvability, based on the history of its previous borrowings and reimbursements, as well as on its objective possibility of encashment regarding its receivables from its debtors, and therefore be able to settle its own financial obligation. The specific manner in which banks can transfer credit risk that is associated to their financial assets is represented by the so-called credit derivatives (Radocea, 2005, p. 21).

Creation of the capital markets' practice within the Anglo-American space, credit derivatives are standardized contracts that make the object of over the counter transactions. As their own name shows it, the value of such a financial instrument derives from valuating the credit risk that is associated to the portfolio of financial assets (Radocea, 2005, p. 21). We must therefore consider the frame contract set up

by the International Swaps and Derivatives Association - ISDA, with its 1992 and 2002 versions, or the so-called European Master Agreement of the European Banking Federation – EBF.

CDS actually represent contracts through which a financial institution (the one buying the protection) pays a premium to another entity (the one selling the protection), the later committing to pay a previously established amount in case one of the borrowers (debtors of the buyer) will not follow his obligations, namely will not pay the accumulated debt. The main difference between a CDS and an ordinary guaranty agreement or insurance considering credits, is the fact that the operation is done without the borrower's knowledge, without modifying the initial agreement signed with the client. The premium paid by the buyer depends on a number of factors such as the debtors' credit rating, the product's maturity and possibilities of the borrower defaulting on obligations. For the buyer of the protection, CDS allows him to cover his risks by transferring them upon the seller of the protection.

Consequently, when an insurance company issues such an instrument in order to cover the risk first undertaken by the one granting the loan, the whole package becomes insured since insurance companies should issue this type of instruments based on justified reasoning. This should also be guaranteed through the rating given by rating agencies (such as Standard & Poor's and Moody's) to insurance companies. In other words, the default risk does not refer to the beneficiary anymore, but to the insurance company whose status is reflected through its rating.

Aiming to obtain as many premiums as possible, insurance companies issued far too many such derivatives, without maintaining sufficient capital in case they should honor their commitments. They rather ignored the worst scenario when a large number of borrowers would default on their payments, again the responsibility for signaling the cumulated risks belonging to rating agencies. Moreover, hedge funds, or any other investors as a matter of speaking, analyzed the CDS's market and identified situations in which CDS addressed extremely risky debtors, therefore interested in purchasing such CDS while betting on the debtor's default, this meaning the insurance company would have to compensate the investor. Therefore, instead of directly lending the borrower who would impose a higher risk, the new investor would rather<sup>19</sup> buy CDS issued by the insurance company (which imply

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<sup>19</sup> The attractiveness of these derivatives for investors relies on the fact that they only assume paying (usually quarterly) a premium that is calculated as a percentage of the instruments' notional value, while the debtor's default involves the owner of the instrument receiving from the insurance company the entire notional value of the contract, his gain only being therefore diminished by the value of the premiums that were already paid. That is how the investor hopes on the debtor's default while the insurance company bets on the debtor's ability to handle all his commitments, this bringing encashment of premiums without any effort on its behalf. Meanwhile, the real problem in this game of financial engineering is creating some values that are not connected to reality as real value added supposes. Another reason for CDS market doubling from year to year since 2001 to 2007 is owed to the fact that the buyer of the protection doesn't need to own receivables toward the debtor in order to buy CDS. Everything the investor needs to do is bet on a debtor's default, pay the premium towards the seller and wait. For a matter of facts, most CDS contracts are bets on debtors' ability of honoring

lower risks) hoping that the debtor will default on his obligations and the insurance company will compensate him in accordance to the foresights of the purchased instrument. Furthermore, the naivety of insurance companies is predictable, them being tempted by the thought of collecting even more premiums, and considering that the risk won't happen. This is how they ended up issuing CDS whose values are larger than the value of the corresponding credit contracted by the debtor.

The attractiveness of these instruments created in the market unthinkable connections. The big problem is that one debtor<sup>20</sup>'s default can implicitly generate for the insurance company obligations towards a series of investors who bought CDS on that debtor, the value of the sold derivatives sometimes surpassing the value of the credit that was initially contracted by the debtor. Even when considering an optimistic scenario that supposed the insurance company being able to respect its commitments, this could significantly affect its capitalization and therefore bringing a lower rating and decreases in the value of the already signed contracts. Furthermore, the reaction of those investors in CDS that had direct relations with the debtors (the ones actually buying protection) is again predictable since the insurance on the debtor's debts now becomes more riskier for them.

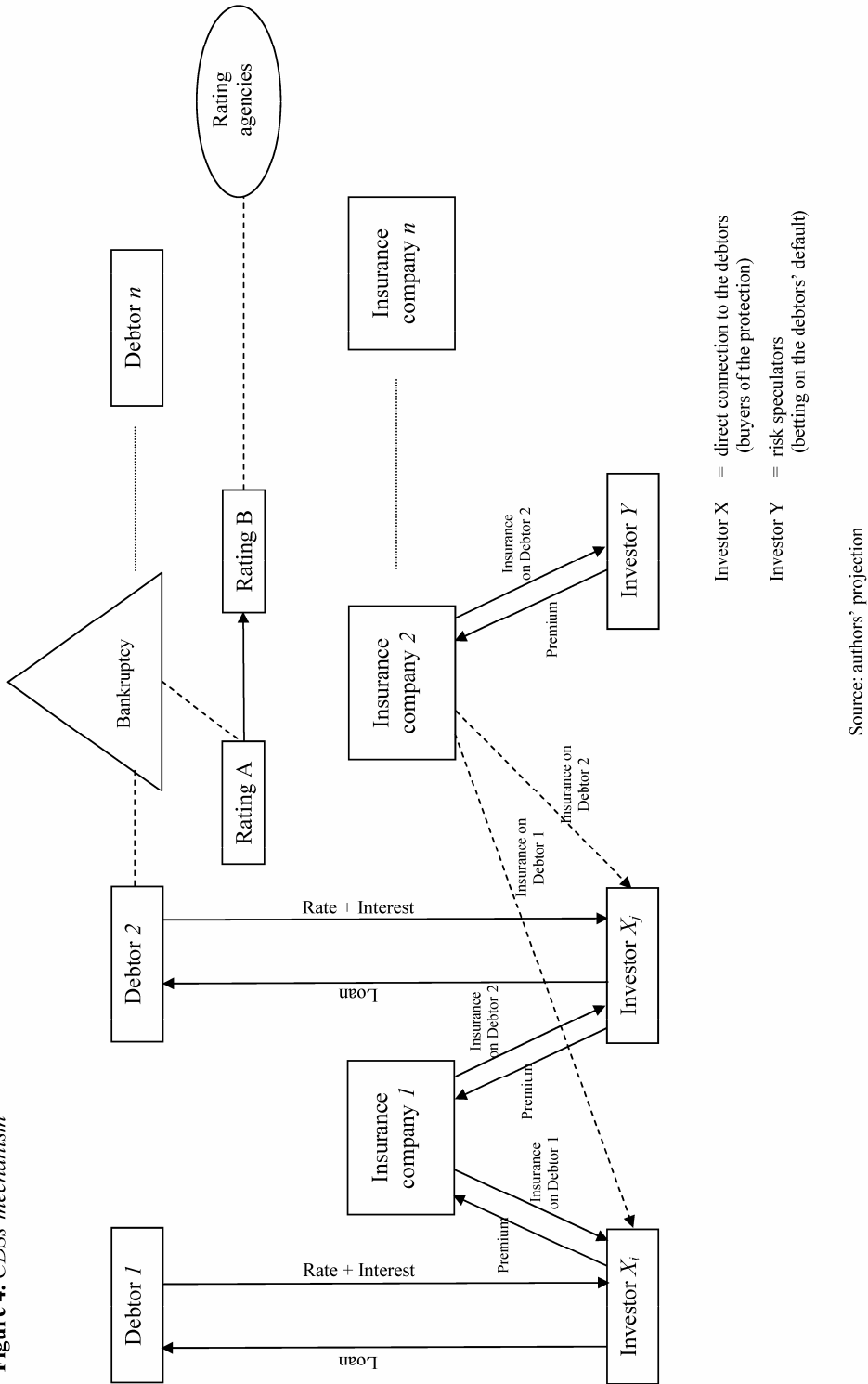
Insurance companies possibility of issuing contracts with uncontrollable values without meanwhile maintaining the adequate level of capital, correlated with the interests of different investors on the market, all framed within two essential assumptions, namely that ratings given by rating agencies were correct and that insurance companies are able to honor all commitments corresponding to all issued CDS, created an extremely dangerous environment, waiting for the sparkle to launch the disaster. The collapse of a large company can therefore attract a domino effect that would bankrupt hundred of other institutions and entities, being connected through CDS and similar derivatives. However, maybe this is what Warren Buffett (2003) was thinking about when he said that derivatives represent financial weapons of mass destruction. The next figure illustrates how CDSs work:

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their commitments. Therefore, a product meant to be a hedging instrument became a possibility for investors to bet on almost any transaction within the credit market.

<sup>20</sup> The presentation of the derivative was simplified in order to simplify its understanding, but the real phenomena took significantly larger proportions.

Figure 4. CDSs' mechanism



As we can see, the same loan contracted by the borrower (debtor) can in the same time be structured into complex derivatives through securitization and subjected to issuing CDS, therefore generating an extremely high risk. What we must always keep in mind is that each contract involves two parties, one still recording gains. What is clear though, is the fact that all these facts are not the result of fair value accounting. It is our opinion that even through difficult times information provided within financial statements must reflect what is happening on the market. Providing adequate information concerning the techniques and assumptions used in determining fair value represents a good way of insuring informational transparency that is vital for investors (Seidman, 2008).

### **From mechanisms to consequences: the propagation of the financial crisis**

It is nowadays obvious that the crisis' effects have been propagated even within those economies that first saw optimistic scenarios, hoping that a certain shortcoming of their national capital markets that were less developed would turn into an advantage, the low market efficiency theoretically representing an obstacle in transmitting information. The first signs of the crisis became known by the middle of year 2007, on the subprime market segment that represented 15% of the total mortgage credit market and which is responsible for more than half of all credit defaults (Tarus, 2008). Another factor stimulating the crisis was financial institutions' loose policy in the USA, who used low interest rates by 2003 – 2005 in order to help the market recover after the IT crisis in the '90s.

After the looses investors recorded through IT investments, many of them started to look for what they considered to be safe investments, without properly analyzing the products they were buying. They were only assuming that real estate, which was quite tangible for them in comparison to the value of securities of an online portal, represented a safe investment, ignoring the possibility of a number of factors interacting and sometime generating significant price decreases. High level of demand for real estate on the market implicitly generated the prices in that field to rise.

From hereafter, the chain reaction operated on different levels: high prices for real estate determined the raise of demand for mortgage credits, while creditors were more and more willing to accept exotic derivatives, which were flexible, but also riskier. We are referring here to credits with low initial interests and no advances required, but which in time imposed high burdens for the borrowers who did not afford the rates that became larger. The vicious circle was therefore created based on unconscious loans undertaken by the beneficiaries, but also on irresponsible lending policies of financial institutions (Tarus, 2008). However, once the beneficiaries could not handle their commitments any more, all problems came to the surface. The incorrect valuation of risks associated to these debts became obvious and implicitly the real estate market fall, further inducing a domino effect upon all derivatives they were backing. Even when borrowers gave up the mortgaged assets, banks were not

able to recover the loaned amount since prices on the real estate market were extremely low, houses being less valuable than the credits they carried.

This virus of the mortgage credits on the subprime market was projected within the entire global credit system through the above presented derivatives that reached portfolios around the world. All these risks becoming acknowledged further induced a confidence crisis, once again propagated within the whole global credit market. This determined loans on international markets to be very expensive, now creating a liquidity crisis because of the fact that banks were limited the access to cash necessary for them to carry out their lending activities.

This was how the crisis first started on the subprime market in the USA managed to find its way into the global credit market, national banks being forced to deal with raising costs for the money borrowed from creditors outside their country. Translated for credit beneficiaries, this means credits that are more “expensive”. This does not mean that developing countries did not also promote irresponsible lending policies on their own, but often on different levels. Panic and lack of trust that was this way generated on the market is just even by only thinking of world wide well known financial institutions, mostly banks, which went bankrupt during the crisis.

Going back to current circumstances, it is quite difficult to delimit which are the actual problems and which are the causes. It is certain that in the financial system, the one that should mobilize financial resources with the purpose of adding value in the economy by assuring the transfer of the disposable capital between the investments or the projects, nowadays stopped to accomplish this function, being more interested in self-preserving. The main factors that led to this situation are, really, those derivatives, now called toxic assets, created based on complex structures, but which depend in fact of mortgage credits offered by banks and the previously described mechanism. In the moment the interest rates grew, the beneficiaries started not to pay their rates and interests at time, this being a mass phenomenon, it is explicable why the real estates’ prices fell. In this phase, already there was a series of banks that had portfolios of derivatives such as CDOs, whose value has constituted a major problem for banks. A significant decrease in the value of this type of assets, now toxic, could evidently lead to a lower value of the assets related to the bank’s debts, and implicitly to negative equity. A comparison can be made here between the situation of the beneficiaries who now own houses at a value much lower than the contracted mortgage credit, and the situation of the banks that in a similar manner through the same effect, has now an asset portfolio much less valuable than their debts, both reaching as a conclusion to a negative equity (Matis and Bonaci, 2009). Moreover, market prices of the banks’ shares fell significantly, resulting in liquidity problems and nobody trusting the bank loans.

Data presented by the World Bank showed that after only 10 years from the appearance of CDS derivatives, the market for CDS contracts reached 54,6 billions \$, while the global economy Gross Domestic Product in 2007 was only 54,3 billions \$. We therefore remember professor Tinker’s words (2008), who said that starting from

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the false premise considering some institutions are *Too Big to Fail* we ended up to circumstances showing us that they are actually *Too Big to Save*.

### **Concluding remarks**

What is now obvious is the fact that the current financial crisis has opened for discussion certain areas within the capital market that are less regulated and controlled, such as mortgage markets and derivatives markets. A clear effect the financial crisis has is the rethinking and reforming of the financial systems through the introduction of new measurement systems and valuation of financial risks but also through higher control on behalf of regulatory institutions, where investment funds, pension funds, life insurance funds and mortgage credits are concerned (Paun, 2008). We therefore find it appropriate that, under normal circumstances, assets should be valued at what they are worth from the market's point of view, the market being the only valid standard of value. On the other hand, we do not know exactly what to do when the market does not function normally ... what standard do we apply then? (Wallison, 2008).

Our pleading in favor of the concept of fair value is not meant to argue that this concept is flawless, in the same time being aware that current standards will for sure be further amended to better suit the accounting information market's needs, as even IASB<sup>21</sup>'s president suggested not long ago (Tweedie, 2008). The goal given to fair value accounting and market based valuation, does not seem so exaggerated if we integrate it in the whole picture that presents financial markets' characteristics in a constantly developing environment that keeps facing us with lessons learned from past crisis. Restricting the use of fair value accounting not only that it would not heal the wounds of the actual financial crisis, but on the contrary it would risk to make them worse, diminishing the trust level that investors have in financial statements of financial institutions (Veron, 2008). Other changes are necessary for facing the crisis' challenges, changes that should solution the deficiencies revealed at different levels.

However, beyond the fair value concept itself, it would be advisable to approach the implementation aspect, often underestimated, especially at Europe's Level (Veron, 2008). The quality and consistency at an international level, regarding the implementation of an accounting referential are vital to assuring a financial stability, as the Banking Supervision Committee shows within Euro system, still before the first signs of the crisis (European System of Central Banks – Banking Supervision Committee, 2006).

It is our belief that the current orientation towards market-based valuations, in risk management as well as in accounting purposes, which we consider will persist at international level, also solicits certain abilities of the valuers, abilities that should be proven. The institutions would have to prove the capacity of performing intelligent and justified valuations of assets and liabilities within the balance sheet, these including complex derivatives as the ones found in the centre of the current

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<sup>21</sup> International Accounting Standards Board.



financial crisis. As in the case of a driver's license, these proves have the role to offer the entity's auditors a reasonable assurance that the valuator has sufficient knowledge and abilities in order not to create any damage towards any implied parties (Deventer, 2008). Unfortunately, the current financial crisis brought to surface severe cases, where no valuation at all is done before committing to an investment and where alternatives were not even searched for achieving some kind of estimations upon the market value, when the considered derivatives were less traded. To these we can add those cases in which inadequate valuation models were used, without giving any helpful information in taking a fundamental rational decision.

What the current financial crisis has confirmed regarding fair value, is that the most dangerous situation is created when the entire valuation process is based on the entity that transactions the securities, without existing any independent confirmation of the created values, from an auditor or from an entity responsible for risk management (Deventer, 2008). We refer here to the 3<sup>rd</sup> level input data that is allowed only as a final alternative, in the impossibility of applying the previous two. In addition, in this case, accounting standards solicit the disclosure of information that would fully permit the investor to give a certain trust degree to the valuation process, taking the best decision in the given circumstances.

As for the banking industry's argument that fair value would be irrelevant within inactive markets, this would mean that using fair value accounting would not offer any type of useful information to investors, regarding the true economic value of the concerned derivatives. Nevertheless, as it was previously shown, the decrease in fair values of those derivatives issued in the last years is fully correlated with the significance of the default degree in comparison with what was expected at the initial moment of the issuance. Since these fair values have the capacity to estimate the impact of a higher degree of defaults upon the future and present earnings generated by these derivatives, we assume that we cannot consider them lacked of significance. Also based on these assumptions, we consider that a present or future limitation of fair value accounting would just 'hide' current realities, only making the mechanism's effect that has triggered the financial crisis longer.

In a valuator's opinion, one of the positive effects of the current financial crisis is that of bringing some light upon those debates that concerned the concept of fair value, from two key aspects' point of view, urging us to give up a certain accounting utopia that kind of took over the current environment, and get back to financial realities (Rérolle, 2008). The first aspect refers to the fact that from a conceptual point of view, creating a balance sheet that has the ability or that needs to offer a true and fair view of the market value of the entity is a great ideal, while the market is far too complex in order to be captured by an accounting system.

The second aspect is that the valuation process involves a high degree of subjectivity, and framing this process by a series of accounting rules may be dangerous. (Rérolle, 2008) appreciates that luckily, restrictions imposed to patrician valutors were quite relaxed. Therefore, simply offering larger and more powerful doses of fair value within accounting trade literature did not necessarily generate a

more realistic image of the entities. Even more necessary is the acknowledgement of both limits of accounting through its nature, and complexity of economic reality whose reflections needs to be accomplished.

Placing value in the center of accounting standard setting bodies' reasoning may induce some assumptions regarding to information being efficiently transmitted within the market, generating securities' prices that represent a true and fair reflection of the entities' performances. All these are happening while each financial crisis brings significant doubts concerning the above-mentioned association. We therefore can state that we are dealing with a valuation crisis

...from many points of view, the current financial crisis is connected to valuation (Noyer, 2008),

but at the root of this crisis we actually find the growing complexity of the value creating mechanism, the recurrent dynamic between market value and fundamental value, and last, but not least the amplification of the gap between our own intellectual models concerning value and the new paradigm of value. Fundamental value of an entity mainly depends on how its assets are put into good use, but we cannot ignore the opportunities the entity might hope to have in the future based on her position or strategy.

In order to create value, a company must generate and maintain decisive and long lasting competitive advantages that allow it to put its assets into good use, exceeding the cost of its capital (Rérolle, 2008). In a global economy, that involves intangibles, competitive advantages can be difficult to recognize (Rérolle, 1998). Economic benefits and costs of an alliance or temporary understanding with a business partner or even a competitor cannot be clearly identified. Uncertainty towards the origin and beneficiaries of future cash flows is determined by the intangibility of some assets and of the offer itself (Davis and Meyer, 1998).

We consider that all these issues that are nowadays raised on improving transparency where fair values are concerned will lead towards the origins of the problems, making us acknowledge basic theories of capital markets. Another aspect of the truth we cannot forget is that investors make their own adjustments upon available information while using it for their own needs. This approach would reduce to a certain degree the importance of the information first being processed by entities and trapped within accounting regulations. As Rérolle (2008) quite properly puts it, the market needs transparency to a greater degree than it needs standards.

We conclude our pleading by saying that fair value can under no circumstances be considered guilty for the current financial crisis, but only its messenger. This would also explain some of the reactions connected to accounting information, since we all know what the general reaction towards the messenger is. Fair value has the role of bringing us closer to reality, but it can only be done through correct implementation and high level of transparency. As for its shortcomings, we consider

they can be reconsidered and adjusted in time, financial markets being extremely favorable for developing a series of innovations that must be closely monitored.

As we are all currently witnessing, derivatives can easily have negative effects. That does not mean that we should forget their ingeniousness in offering the opportunity to separate risks from their source and lead them to parties that are willing to bear them while getting a chance to a matching reward. The simpler a derivative is, the fewer places for manipulation it leaves, but this does not mean that derivatives should be completely eliminated. Where do these instruments become toxic? Exactly where they lack transparency and therefore information, and we cannot think of a better concept of value that aims at offering more information than fair value does. How this will actually be done remains to be seen, but one thing is for sure. We cannot sacrifice such a concept in order to find a “scapegoat” for the current financial crisis. The precise process through which fair values are reached needs to be acknowledged to investors in order to regain their trust, as current international accounting regulations also require.

Once again, we will all have to learn from the crisis, while each chain of the financial system must review its role, attributions and responsibilities, permanently encouraging informational transparency. If this entire pleading still didn't succeed in bringing you over to the side of fair value, we conclude by saying about fair value accounting what Churchill said about democracy, namely that it is the worst system with the exception of all others.

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