

Chapter 76

Role of Accounting and Audit in the Recent Financial Crisis

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ABSTRACT

This study aims to assess the role of accounting and auditing in the recent financial crisis. After each crisis, there have been serious discussions concerning the reasons behind those crises. However, no consensus has yet been achieved until now. In this context, the analysis of the relationships among financial crisis, accounting, and auditing is of utmost importance in better evaluating the structural reasons behind the crisis. There are several points that this chapter aims to analyze to indicate the contributions of accounting and auditing to the recent global financial crisis. These points are: impacts of disregarding the main principles of accounting, the wide use of fair value accounting over cost-based accounting, incorrect and misleading financial and audit reports, applications of creative accounting, and lack of transparency and weaknesses of the auditing process. The debates generally concentrate on the use of fair value (mark-to-market) accounting in the financial reports as opposed to the historical cost method. It should be emphasized that accounting is very important as a key mechanism of market economies, because of its crucial role in the functioning of the markets in accordance with the public interest. The chapter concludes with several suggestions by taking the fact into consideration that accounting and auditing systems should be revised for the better protection of interests of the third parties such as investors, potential investors, and the state.

INTRODUCTION

There have been several financial crises since the 1929 Great Depression with differing impacts on the financial markets and economies. After each crisis, the reasons for that crisis were seriously

debated, but no consensus has been reached until now regarding the common causes of them. In this respect, the analysis of the relationship between financial crisis and accounting is crucial in order to better evaluate the structural reasons behind the crises. This study aims to determine the structural reasons of the faulty accounting practices and to

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suggest solutions for them by analyzing the roles of accounting and auditing in this crisis.

What are the roles of accounting and auditing in this global financial crisis? Several analysts claim that the recent financial crisis occurred due to the defects of accounting and auditing. Accounting and auditing have never been this much criticized before regarding their relations with the financial crises. Would it be really right to blame accounting and auditing for their contributions to the 2008 financial crisis? Can accounting standards be blamed for the financial collapse? Do accounting and auditing have a serious impact on the occurrence and spread of this global financial crisis? Did fair value accounting play a key role in the recent financial crisis?

There are several reasons that made the recent financial crisis more severe than the previous ones. Globalization has created many intertwined economies, whose interrelationships have dramatically expanded mutual dependencies and led to interdependencies (Read, 2009). It should be therefore emphasized that this crisis is the first global financial crisis occurred in the financial history. The main reasons of the severity of this crisis in addition to its global character are as follows: to allow the financial system to take excess risk than it can bear, not to be able to correctly price the assets and lack of sufficient financial transparency in the financial markets.

BACKGROUND

This study will try to elaborate the following main points concerning accounting and auditing with the aim of evaluating their contributions to the recent global financial crisis:

- To disregard the main principles of accounting,
- The widely use of fair value accounting over cost-based accounting,

- Incorrect and misleading financial and audit reports,
- Defaults of the legal institutions in the formation of the accounting standards,
- The applications of creative accounting,
- Lack of transparency and weaknesses in the auditing process.

As Hyman Minsky pointed out long before the recent crisis, the finance sector has a tendency to cause crisis because of its nature, which may lead to instability. For this reason, it needs to be regularly audited (Hic, 2009). The principles of accounting such as the principle of regularity, the principle of consistency, the principle of sincerity, the principle of permanence of methods and the principle of prudence need to be emphasized because these principles have been disregarded recently by some companies (Kutlan, 2009). Among these principles, prudence concept is perhaps one of the most related principles with the recent financial crisis. The principle of prudence means that if the market value falls below the cost of the asset, the company must recognise the loss straight away, but if there is an expected profit, it should wait until the asset is sold before the profit is recognised (Butler, 2009). The recent financial crisis has indicated that financial tables prepared according to the International Financial Reporting Standards (IFRS) cannot provide trustworthy and sufficient amount of information about the company to the outside users such as investors, creditors, potential investors and the government.

In this respect, one can realize the difference between the fields of finance and accounting. As Cunningham (2005) points out, finance may diminish the relevance of accounting information in the case of company frauds such as Enron. The proper implementation of accounting principles mentioned above provides the healthy functioning of business relations among the parties. An accounting system, which does not comply with these accounting principles, has the possibility of

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