

An Economic–Financial Approach to Ethical Sentiments and the World Financial Crisis

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Abstract

The research problem motivating this work is the devastating effects of the current financial crisis and economic recession on the nations of the world. The primary research question addresses what should be done in an ethically appropriate way to recover through a more sustainable set of actions. One of the main characteristics of a successful financial system is in its transparency and accountability. Financial reports are the essence of any rational decision making involving investment and/or lending in and/or to the corresponding corporations. Financial markets, instruments, derivatives, and the corresponding technologies are so rapidly evolving that each would necessitate a dynamic learning and educational preparation for the regulatory agencies. Among other things, regulatory agents, and policymakers should ideally be required to be certified by a very reputable certifying agency to be qualified to engage in and/or initiate any financial legislation at any time. Various aspects of financial reporting relative to the current financial shocks along with some appropriate policies will be analyzed in this paper. In conclusion, there will be a recommendation on what to be optimally done.

I. Introduction

An Overall Review Of The Global Financial Crisis

The research problem motivating this effort is simply summarized in the fact that the current financial crisis, started mainly in the U.S. in the late November of 2007, has devastated millions of individuals, businesses, and decision makers around the world. According to Butrica, Issa, and Soto (2009), “the retirement savings of American households took a big hit when the stock market crashed in 2008. Recently, however, a good portion of these losses has been reversed.” In the same report, they have indicated that while the retirement accounts’ assets drastically declined by 33 percent—or an amount of \$2.8 trillion—within the period of 2007-2009 (first quarter), since then account balances have rebounded sharply, as reflected in the above figure. Between the first and the third quarters of 2009, retirement accounts gained roughly \$1.3 trillion (23 percent). The figures for the third quarters of 2007 and 2009 were \$8.6 trillion and \$7.1 trillion accordingly.

As it is now a public knowledge, the epicenter of the global financial tsunami of November 2007- 2009 was in the U.S.A. Looking at high rate of indebtedness of several major investment bankers, it may be clearer, with retrospect, why a big turbulence had to be soon

realized in 2007. The ratios of total debt divided by the stockholders' equity, the leverage ratios, were generally above 30, which were simply too high.

The growth of the financial industry relative to the entire growth of the economy, as depicted in Figure 1, would surely highlight the sensitivity of this industry to any major shock.

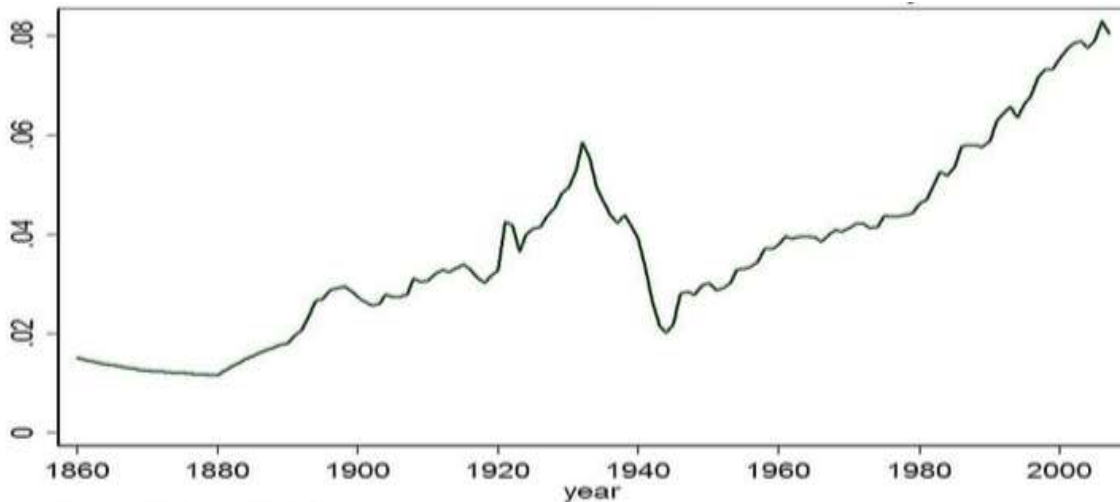


Figure 1. GDP Share of U.S. Financial Industry
Source: Thomas Phillippon. 2008. The future of the financial industry.
<http://sternfinance.blogspot.com/2008/10/future-of-financial-industry-thomas.html>

The financial industry's heavy debt, on the one hand, and its assets' low quality, characterized by heavy investment in subprime mortgages, extended to too many risky borrowers, on the other hand, were even more promising to be detrimental to the financial system, and the economy as a whole. Figure 2 is a clear demonstration of what had to happen in absence of some reliable lending criteria. It was like a real tsunami that took away many homes and false as well as legitimate hopes of hundreds of thousands of people along with their jobs and links to a normal life.

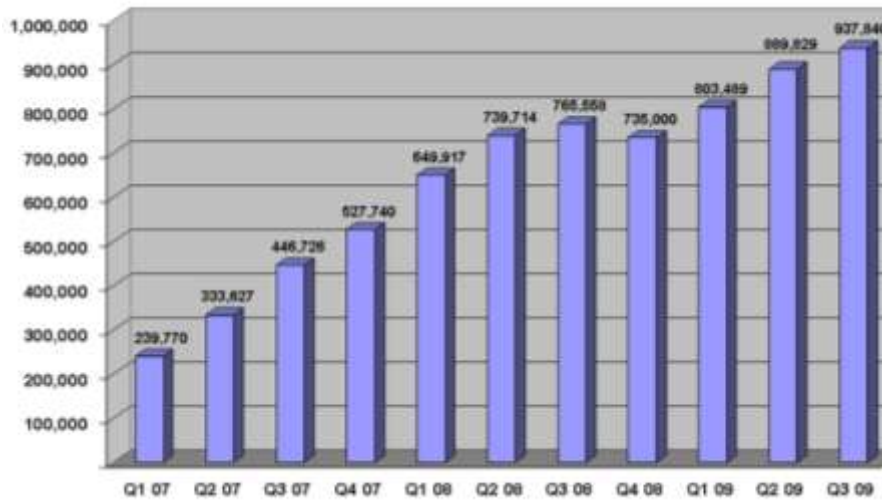


Figure 2. U.S. Properties with Foreclosure Activity
 Source Data: Realty Trac Press Releases of “U.S. Foreclosure Market Report”

The Financial Services Modernization Act of 1999 (Gramm-Leach-Bliley Act) Act eliminated Glass-Steagall restrictions. Securities firms and insurance companies were allowed to own commercial banks and commercial banks were enabled to underwrite insurance, bonds and shares of stocks (Miller and VanHoose, 2007). Despite historical worries and warnings on the dangers of the risky mixture of the two activities, it finally happened and most possibly played a major role in deterioration of the current world’s financial crisis.

One of the reasons for the recent financial crisis in the U.S. has been the excessive growth of consumption along with outstanding debt for the U.S. household. In TABLE 1, as reported by Galston, William A. (September 1, 2009), it is clear that since 1951, consumption, as a percentage of GDP, has never been as high as it was in the period of 2001-2008.

TABLE 1 PERSONAL CONSUMPTION AS A PERCENTAGE OF GDP, 1951-2008

<i>Period</i>	<i>Average</i>	<i>Beginning</i>	<i>End</i>
1951-1960	62.3	61.5	63
1961-1970	61.8	62.8	62.4
1971-1980	62.5	62.3	63
1981-1990	64.6	62	66.1
1990-2000	67.3	66.4	68.6
2001-2008	69.8	69.5	70.1

Source: Galston, William A. (September 1, 2009).

Johnson (2009) reports that U.S. elderly segment of the population have become more participating in the labor force, reflecting their need to work at older ages due to the recent economic pressures. For the years of 2007 to 2009, the average male participation rate within the ages of 62-64 years was raised by 4.5%, and by 2.0% within the higher ages of 65-69.

As to the prospective expected economic changes, according to Galston (2009), after some time the current crisis is settled, and a new period of normality may be characterized by lower household debt, higher personal savings, and less consumption, as a share of GDP. This transition in turn will impact both the domestic and the international economy. There will be some reshuffling of the U.S. domestic production from the currently bloated retail infrastructure into more focus on exports. Externally, many countries focusing on economic growth through mainly depending on exports will have a harder time to sell abroad and will inevitably shift toward domestic consumption. That would ultimately lead to diminishing savings rates—and pretty soon—a tangible reduction in their appetite for U.S. government debt. In absence of U.S. government's enough access to foreign capital more pressure will be imposed on the U.S. fiscal policy.

According to William Gale (July 8, 2009), 75% of the U.S. Federal government spending is on five things; Medicare, Medicaid, Social Security, net interest, and defense spending. It will be extremely hard to cut spending on those items in the next 5 years unless a massive cut would be possible on all other budget items, which could hardly be possible. While short-term fiscal stimulus was necessary, the medium-term and long-term deficits are highly risky.

According to the U.K. National Audit Office, in the U.K., the cost of rescuing the banking industry has been \$1.4 trillion (TD-Ameritrade, Market Watch, December 3, 2009, p.1). That amount has included “the cost of buying up shares in lenders Royal Bank of Scotland and Lloyds Banking Group as well as providing 250 billion pounds of guarantees, 280 pounds of insurance on toxic assets, 200 billion pounds of Bank of England loss indemnification and 40 billion pounds of loans.”

Suggestions for government fiscal policy to bring back stability are not in any shortage. Among others, even a conservative politician, Mitt Romney (USA Today, December 3, 2009), suggested installation of a dynamic regulation, being updated regularly, free the trade, limiting spending to the absolutely needed projects, friendlier tax policies on businesses and household, helping small businesses grow, tax incentives for business new hiring, using some of the unused stimulus funds for job creation priorities.

The crisis that was revealed in September 2008 started with the real estate and financial markets and pretty soon, it expanded into the world through an integrated global market. The UN Secretary General stressed that (Hashmi, November 2008, p. 1): "We are facing a financial crisis of unprecedented scale in a world that has never been so interdependent. The consequences are global. The situation is unstable. The current financial crisis is rapidly being transformed into economic crisis and could lead to a social crisis in many countries."

II. The Current State Of The U.S. & The World’s Economies

Is the well-known market economic system about to collapse? This research offers a negative response. Competition has proven overwhelmingly to be the most efficient, if not equitable, way of life in most countries. One of the repeated market problems, as recognized by almost all economists, has been in the externalities, imbalanced information, and a clear lack of governmental fulfillment of some public responsibilities in protecting all sectors of the economy most actively and responsibly. Externalities are supposed to be internalized by appropriate government policies. Ethical standards and rule of law are supposed to be implemented and enforced. One may think of a freely competitive system as a beautiful and fruitful tree that needs some pruning every now and then. A tree is not supposed to be cut out or put in death just because of some redundant branches. A constructive competition necessitates its own ethical rules and discipline.

Adam Smith, one of the most distinguished pioneers and advocates of free-enterprise system, had spent years in learning and teaching moral issues as Professor of Moral Philosophy. He published his *Moral Sentiments* in 1759, well in advance of his well-known *The Wealth of Nations*, in which, according to Cannan (1976, p. xxxvii), he clarified his proposed notions of the general principles of law and government through analyzing different revolutions governments have gone through in various ages of society. All issues within the object of law, concerning justice, police, revenue, arms, etc., preceded Smith’s lectures and writings of economic issues.

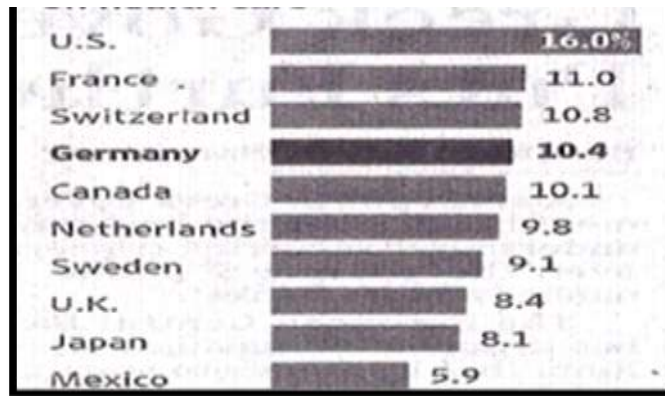


Figure 3. Percent of GDP Spent on Health Care
Sources: OECD and Wall Street Journal, November 18, 2009, p. A12

In the U.S. a huge percentage (50% in 2005) of the total cases of bankruptcy in the recent years, were due to their high costs of health care (see Heriot, Gail, February 11, 2005). In Figure 3 a good contrast of various (mostly advanced) economies on the issue of health care's toll is illustrated.

Another optimistic view of the future in the U.S. is continuous expectation of rather low inflation for some time, as reported by Haubrich (2009, p. 2).

A low real interest-rate environment, as reported by Haubrich (2009), could not incentivize lenders to lend more and savors to save more. This is encouraging though to many good-standing businesses and individuals to have easier access to credit. At this point and for some future times, such low real interest rates are not going to be changed noticeably till some sustainable recovery is established. Given lower nominal interest rates than expected inflation, real interest rates in the U.S. have been practically negative.

According to Business Wire (November 23, 2009, p.1), Citi's Investment Research and Analysis group in their annual "Prospects for Economies and Financial Markets for 2010," indicated that there will be a strong and sustained recovery in 2010. The initial growth in output will likely be quite solid and will also be realized across major economies through early 2010. It is further reported that: "After this initial burst, Citi expects sustained momentum in Asia (excluding Japan); a fairly strong recovery in the U.S. and more gradual medium-term recovery in Europe and Japan.

Xin and Subler (December 18, 2009) reported that "it is getting harder for governments to buy United States Treasuries because the US's shrinking current-account gap is reducing supply of dollars overseas, a Chinese central bank official said yesterday." This is an indication of the U.S. dollar recovery, which must be considered in considerations of dollar-denominated transactions. China currently holds a huge foreign currency reserves, about \$2.3 trillion of which are in U.S. dollars and tied up to their holdings of U.S. Treasury bonds. China is the greater creditor to the U.S. government.

The financial turbulence experienced by many depository institutions around the world has been also revealed in Dan Keeler's report (August 2009). In his World's 50 Safest Banks 2009, only five U.S. banks are listed in the 32nd, 39th, 42nd, 47th, and 49th ranking.

Restoration of Public Confidence: An Economic-Accounting Perspective

Financial Reporting & Accounting Aspects

Rajan and Zingales in their *Saving Capitalism from the Capitalists* (2004), stress an important view that capitalism needs to be stabilized through some well-defined rules and regulations. It has to regulate the system to be accessible to all, not just a few, and therefore conducive to more competition. They propose that the behavior of government is guided by the public mood but also to a large extent by the special interest groups. That is why capitalism is fragile, which is not an economic but a political problem.

The 1987 financial crisis, according to Allan H. Meltzer (in Kamphuis, Jr. et al, 1989, p. 1) could be explained by reasons all “grouped under three headings: reductions in anticipated future earnings, rising interest rates, and increased uncertainty, particularly the effect on volatility and uncertainty of computerized trading and index arbitrage.” At this time due to the deregulation in the sense that the world markets not just the U.S. fell in crisis. In fact, the difference was that U.S. markets were relatively affected less adversely than most of the other major markets. Richard Roll (Kamphuis, Jr. et al, 1989, p. 4) reported that: “of 23 major markets, the U.S. had the fifth smallest decline, that is, the fifth best performance. Markets in 19 of the 23 countries fell 20 percent or more. In local currency units, the minimum decline was 11.4 percent (Austria), the maximum was 45.8 percent (Hong Kong).”

The author proposes here that it is ethically essential that governments protect the public interest in limiting capitalists’ excessive influences. The regulators are supposed to understand all the technical sophistications of the modern markets. They must be required to gain accreditation and be officially certified through renewed knowledge and appropriate training about dynamic evolution of financial markets, instruments, derivatives, and many innovative contexts of system abuses, most of which have happened simply due to the lack of understanding of the regulatory agencies for quite some time.

It has been critically important to many (e.g., Lester Thurow, 1985) that a sustainable society cannot be a reality unless if there are enough of state provision of social insurance, health care, and education. In absence of a sense of public trust and relative stability, even major capitalists and investors have been historically affected by the adversity of social unrest, lack of commitment of the working class, and a blend of lower (opportunity) cost of tardiness and less benefits at risk. Stabilizing a nation’s foundation would cultivate the grounds for more productivity and prosperity for all.

According to Reckers et al (2007), declining investor confidence was a world-wide not just a North American issue. They studied and found the incremental impacts of audit firm and partner rotations on the perceptions of confidence levels in capital markets. Participants for the studies were from the legal and business community. Mikhail, Michael, et al (2007), studied “*When Security Analysts Talk, Who Listens?*” and found that unlike what is believed by many,

both small and large traders react to analysts' reports and expected earnings forecasts revision. However, they reported that large investors react and trade more than small traders in response to the analyst's recommendation and earnings forecast revision.

Worldcom, the big telecommunication corporation, after having to revise their accounting statements twice in 2005, showed that operating profits were some 35% lower for the past three years than originally reported, as depicted by Moritz (August 12, 2002). This was one of the several cases which eroded public's trust in the financial reports and credibility of many reputable auditors, such as Arthur Anderson. The necessary trust has been and will remain to be a scarce commodity for several years.

Most Recent Education-Focused Response to The Global Financial Crisis

The International Federation of Accountants (IFAC, December 2009) released a publication to enhance the knowledge and understanding of the members of some world-wide standards in response to the recent global turbulence. One major challenge faced by the profession is the issue of assessment of the participants' learning and competence in the educational opportunities provided by—and in compliance—with the International Accounting Education Standards (IAES). IFAC (December 2009) has clarified the following general guidelines:

Assessment: Measurement of the Effectiveness of Learning and Development:

30. Different measurement approaches can be employed to assess the effectiveness of learning and development. They include:

Input measures: An input-based measure focuses on the investment made in learning and development, for example, the number of hours an individual is expected to attend a course.

There are significant legal and regulatory differences in the point of qualification (or licensing) internationally; qualification may occur from very early to very late in a career. Each IFAC member body may define the appropriate link between the end of IPD and the point of qualification (or licensing) for its members or the subject areas covered. Input-based measures have traditionally served as proxies for measuring the development of competence, primarily because they are easy to measure and verify. They do not, however, measure the competence developed.

Process measures: A process-based approach focuses on the design and delivery of learning and development, for example, a course curriculum that is regularly reviewed and updated. As with the input-based measures, process measures are proxies for the competence developed.

Output measures: An output-based approach focuses on whether the professional accountant has developed the specified competence. Competence can be assessed by a variety of means, including workplace performance, workplace

simulations, written examinations, and self-assessment. Competence-based assessment begins with the creation of competence statements as benchmarks.

31. In choosing a measurement approach, the following characteristics should be considered:

Validity—whether it measures what needs to be measured; (b) Reliability—whether it consistently produces the same result, given the same set of circumstances; and (c) Cost effectiveness—whether the benefits outweigh the costs of measurement.

32. Output measures, being directly focused on competence, are rated as highly valid. They can be challenging to implement without substantial investment in measurement systems, leading to concerns over their cost-effectiveness. Because of the inherent compromise between validity, reliability, and cost effectiveness, a mix of input, process, and output measures is often adopted. However, output measures are the measures most closely linked with the objective of accounting education—the development of competence. Also known as competency frameworks, competency profiles, competency models, competency maps, or functional maps.

A Survey And Assessment

In response to an interesting inquiry on how the accountancy profession can provide effective support to small and medium-sized enterprises (SME) and lenders, a global survey of banks on lending to SMEs was recently conducted jointly by IFAC and *The Banker* magazine (October 2009). This was also motivated by the need to better understand the needs of lenders and SMEs' access to financing. Lending activities, as listed in TABLE 2, are reported in terms of number of applications received, on the one hand, and the number of loans actually approved, on the other, for a one-year period of first halves of 2008-2009. Among other things, it is highlighted that in that period, on the net basis, “fewer” and “much less” applications were submitted (42.8% = 32.1% + 10.7%) and also “fewer” and “much less” loans were actually extended (48.6% = 37% + 11.6%). This is surely a tangible factor in at least keeping the deteriorated circumstances from the needed turn around.

TABLE 2 Number of SME loan applications received and approved in the first half of 2009, compared to the same period in 2008

Number of SME loan applications received in the first half of 2009 compared to the same period in 2008.			The number of SME loans you approved during the first half of 2009 compared to the same period in 2008.	
Response	Frequency	Count	Frequency	Count
Much more	7.7%	15	3.7%	7
More	27.0%	53	25.4%	48
About the same	22.4%	44	22.2%	42
Fewer	32.1%	63	37.0%	70
Much less	10.7%	21	11.6%	22

Source: IFAC and *The Banker Magazine: A Special Supplement within The Banker*, October 2009; The author’s Re-tabulation and Data Organization. Note: Respondents could only choose a single response.

To identify the role of accountancy and professional auditing, in the same survey, lenders were asked about the influence of engagement of an external professional accountant (in providing assurance services and/or financial advice to SMEs) on lenders’ loan approvals. As indicated in TABLE 3, the feedback was very encouraging, revealing a rather strong support for the professions’ credibility and trust. A little less than 60% of the lenders placed a ranking of 4 and 5 (for being highly and greatly influenced).

TABLE 3 The Influence of Engagement of an External Professional Accountant (in Providing Assurance Services and/or Financial Advice) on Lenders’ Loan Offerings to SMEs

Responses	Frequency	Count
1: Not a factor	6.7%	11
2	11.0%	18
3	23.3%	38
4	42.3%	69
5: Great Influence	16.6%	27

Source: IFAC and *The Banker Magazine: A Special Supplement within The Banker*, October 2009; the author’s Re-tabulation and data re-organization. Note: Respondents could only choose a single response.

In identification of “very important” factors from the aforementioned survey, as considered by global lenders, in deciding to approve loan extension to SMEs, the author has intentionally extracted only the relevant component of the results for better clarification, which is Summarized in TABLE 4.

TABLE 4 Criteria Revealed by Lenders as “very important”—Compared to All Other Criteria in Approving Loans After and Before the Global Financial Crisis

1. Cash flow information	2. Transaction history/account behavior	3. Collateral	4. Key risk indicators	5. Financial statements accompanied by an audit report
After: 70%	65%	64.8%	51.9%	44.1%
Before: 58.7%	46.7%	39.3%	34.1%	37%
6. Financial statements	7. Industry trends	8. Credit ratings & references	9. Personal guarantees	10. Forecasted/prospective financial information
After: 43.4%	43.1%	38.8%	37.7%	36.6%
Before: 34.1%	15.7%	28.5%	20.4%	19%

Source: IFAC and *The Banker Magazine: A Special Supplement within The Banker*, October 2009; the re-tabulation and data re-organization is made by the author. Note: Respondents could only choose a single response

It is obvious that most criteria that were much less important for loan approvals prior to the global financial turbulence, were re-assessed and became overwhelmingly significant for the global bankers after the crisis realization.

Accounting versus Economic Policy: How to Save Banks?

Many banks have failed in the U.S. during this ongoing financial crisis. One economic policy targeted at saving the economy had to go through saving many banks. Banks, like any other businesses or individuals, fail financially when one of the two things happen to them: the difference between their assets and liabilities become negative, or when the difference is still positive but the assets are not easily liquid (think of bad loans that may not be cashed and returned to the bank). Banks have to pay depositors their deposits (banks' liabilities) back right away or in a short period of time.

Many job losses on the one hand, and bad loans erroneously approved at some point in the past, on the other hand, have contributed to the current bank failures. The Fed and some other depository regulators have decided to buy bad loans back from banks to raise their net worth or equity capital such that they can recover and be ready to lend money again. Now, how should banks' bad loans (bad assets) be appropriately valued? Well, accountants and auditors have most frequently emphasized on fair value. This means if a house's market price is dropped to half, then all the failing bank will get from the Fed would be based on that current market price. This would put a bank in even worse condition.

Some economists, though, have argued that since the home prices will recover sooner or later, the Fed will not lose if they appraise the house at the historical value. In this case, the amount government should pay to the troubled bank to buy its bad loan would be enough to cover the unpaid part of a loan plus what is left of the old not new price. Moreover, that would raise the banks' net equity capital. The point of the dilemma: Why should fair value be the basis in all other appraisal but historical value for these banks?

An Internal Approach To High Performance

Responsibility accounting: Responsibility accounting, which is broadly analyzed and applied (see, e.g., Shoute, 2008; Indjejikian, R. and Nanda, 2003), continues to be a life-saving process at all times, including these financially turbulent periods. Decision centers in the private sector are divided into cost centers, profit centers, and investment centers. In short, responsibility centers are established for enhancement of results. Responsibility accounting, therefore, is all about at least four major steps:

- Look for and identify significant variances in actual versus planned performances.
- Try hard to discover reasons for such variances.
- Fix and adjust responsibility.
- Take a well-defined and timely action, applying critical thinking processes to correct

problems in an apolitical and unbiased fashion.

Responsibility accounting, in its best functioning, effectively incorporates collection, summarization, and reporting of financial information originating from responsibility (or decision) centers. That is why it is also called activity accounting or profitability accounting, in which costs, revenues, profits are most carefully traced out through the primary decision makers and the responsible managers within an organization. So it can be perceived that the more decentralized the organization, the stronger the positive results of responsibility accounting. The funds-for-results concept is a merit-based process of funding, in which the budget allocation may benefit both the better-performing projects as well as the successful responsible managers. Research on incentivizing responsibility division has not been just published. An example for review is “Reply to: Dynamic Incentives and Responsibility Accounting: A Comment,” published by Indjejikian and Nanda (2003).

Some Financial Reporting Challenges

In a joint report by United Nations Statistics Division, International Monetary Fund, and World Bank (February 22, 2009), some aspects of the crisis story are available through official statistics, which include increasing assets to capital ratios of financial institutions imbalances in current accounts, fiscal deficits, and financial cross-border positions for industrial countries growing significantly faster than real activity. It was not a lack of data on proper macroeconomic statistics that caused this recent financial crisis. The speed of the development of the crisis led to an understanding of a need for some sort of reliable leading indicators.

As emphasized by International Auditing and Assurance Standards Board (IAASB, October 2009), it is a challenge to implement an appropriate measurement objective. Fair value accounting is recommended, where the corresponding estimates are expressed in the value of a current transaction or the assets, liabilities, and the equity involved at the measurement date. Auditors’ challenges are real especially when financial markets and instruments evolve into technically innovative conditions, necessitating much more new learning and dynamic education. Assessment of costs, which is supposedly made based on the point they were incurred.

ISA 300 (“planning an Audit of Financial Statements,” paragraph 8) requires an established overall audit strategy for each auditing task (IAASB, October 2009, p. 3). In such strategy, the engagement extent, scope, and financial reporting framework used are to be clearly defined, while industry-specific reporting requirements are also clarified. In banks’ financial statement auditing, or cases where derivative financial instruments are involved, in addition to the ISAs, IAASB (October 2009) has advised that the auditor may additionally look to IAPS 1006 or IAPS 1012 for further guidance. While, IAPS (International Auditing Practice Statement) 1006 addresses “Audits of Financial Statements of Banks,” IAPS 1012 addresses guidance on “Auditing Derivative Financial Instruments.”

Conclusion

In this research, a review of the financial and economic events of the periods before the year of 2007, the official start of the current crisis, is presented. The causes and effects of such a huge shock have been scrutinized. Some effort is made to focus on what may most possibly be in the prospective picture of the economic activity, the financial markets.

The impact of the crisis on financial markets, banks, and the accountancy profession has been reviewed and also, a refreshing empirical exploration is provided by IFAC and The Banker magazine on the fact that this profession, abused by few (though big firms and individuals of influence), is still the well-functioning heart monitor of the global and hopefully, local economies.

The author provides some reference to responsibility-accounting techniques in promoting cost efficiency and profit enhancement of various organizations through decentralization and more accountability of the decision centers.

It is critically important to regulate markets enough to protect public interest from excessive special-interest groups' influences; this would save capitalism from greedy capitalists. Economic stimuli have been projected by many economists as necessary to save various economies from disastrous failure. Social security, health care, and education are all proposed to be necessary components of a sustainable society's mainstay.

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