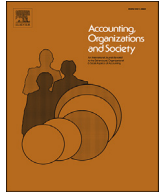




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# Financialization as strategy: Accounting for inter-organizational value creation in the European real estate industry

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## ABSTRACT

Financialization—the increasing relevance of financial markets, financial actors and financial logics—and the related rise of originate-to-distribute-cycles in the mortgage industry have been considered key explanations for the emergence of financial crises. Analyzing a case study in the European real estate industry, we show how actors strategically manage inter-organizational relations and take advantage of rising asset prices, through refinancing on the basis of loan-to-value even before the originate-to-distribute-cycle of the mortgage industry unfolds. Valuation and accounting are core practices of financialized business models that evolve around management fees, which serve as value carriers and bring potential future profits into the present. Auditing also plays a role as it legitimizes these business activities and facilitates jurisdictional arbitrage. We contribute to the accounting literature by explaining how the strategic configuration of a valuation-accounting nexus leads to organizational short-termism and rewards unsustainable business activities in the real estate industry.

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## 1. Introduction

One common narrative of the so-called sub-prime mortgage crisis in the USA interprets loan securitization and respective collateralized debt obligations as one of its main causes (see, for example, Carruthers, 2013; Fligstein & Goldstein, 2010; Ryan, 2008). While we do not refute the importance of these dynamics for destabilizing the economy, we argue that securitization is only one aspect of short-termism in real estate. Finance-driven business models in which valuation and accounting play a fundamental role are equally relevant for understanding the increasing dominance of finance in real estate (Engelen, Fernandez, & Hendrikse, 2014; Stockhammer, 2010), as they complement and precede banks' originate-to-distribute strategies.

Financialization is neither confined to the originate-to-distribute model of the mortgage industry (Purnanandam, 2011) nor to specific services, such as credit ratings, which assess (and co-

create) structured financial instruments (Ashcraft & Schuermann, 2008). Instead, the establishment of value creation cycles through accounting and valuation is a deliberate and carefully managed activity that characterizes much of the real estate industry. More precisely, valuation and accounting are used in a strategic manner, taking advantage of jurisdictional differences and the leeway inherent to recognition and measurement of assets.

In this paper, we investigate inter-organizational relations, in particular, valuation and accounting practices, that bring about finance-led investment strategies in real estate. Our in-depth analysis of operational practices of valuation and accounting reveals the complexity of inter-organizational network relations in which profit generation unfolds. We show how up-front management fees are used to extract capital from envisioned future profits, as long as credit is in ample supply and asset prices are rising. Such finance-driven activities might last a considerable amount of time, but become vulnerable when growth slows, indicating the fragility of such business models.

We intend to demonstrate how “the world of accounting practice is implicated in the current financial crisis in a number of ways” (Arnold, 2009, p. 803). Analyzing organizational linkages between the real estate sector, the financial industry and their orbiting

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services firms, we focus on those accounting and valuation practices that precede the securitization dynamics commonly associated with real estate. In fact, we regard the ‘generation’ of assets just as important to understand the financialized nature of real estate investment cycles. Looking at what one might call the supply-side of financialization, we investigate how inter-organizational valuation and accounting practices advance the emergence of financialized business models in the real estate industry.

Empirically, we provide a critical case (Yin, 2014) of the rise and decline of a particular investment firm purchasing residential property in Germany. More specifically, we show how during the boom cycle of the mid-2000s valuation and accounting were fundamental to acquire more than 20,000 apartments with virtually no equity. While no single case can explain all aspects in financial globalization, our study of the German real estate market provides unique insights in order to unravel the strategic dimension of inter-organizational accounting and valuation practices and to analyze their distributive effects, thereby bringing the worlds of accounting research and ‘accounting in action’ somewhat closer together (Hopwood, 1978). Our findings address the social embeddedness and strategic application of accounting and valuation (Dent, 1990; Hopwood, 2000; Miller, 2008). In particular, we demonstrate how accounting relies upon and feeds back into the escalation of asset prices. Furthermore, we show how accounting practices contribute to short-termism of business models and how management fees, calculated transfer prices and the exploitation of a liberalized European corporate law help to bring potential future profits into the present.

## 2. Theory: financialized business models, accounting and strategic action

Economic liberalization and cross-national market integration, particularly in Europe, have brought a number of financial services firms to the fore that capitalize on jurisdictional arbitrage through actively exploiting the variety of legal, fiscal and professional rules of different jurisdictions (Semmler & Bernard, 2009; Vollmer, Mennicken, & Preda, 2009). The growth of financial markets provides new business opportunities for services firms that offer consultancy and accounting services, and thus, enable huge cross-border capital flows. An “increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operation of the economy and its governing institutions” (Epstein, 2005, p. 3) has inspired a research agenda under the label of ‘financialization’. As research on financialization expands from accumulation regimes to shareholder value and the financialization of every-day life (van der Zwan, 2014), empirical findings increasingly discuss the relevance of organizational complexities (Froud, Sukhdev, Leaver, & Williams, 2006; Kädtler, 2009).

Financialized business activities drive socio-economic change and bring about instability as they lead to employment stagnation (Lin, 2016) and short-termism. Reaping financial benefits from jurisdictional arbitrage and ‘boom and bust’ dynamics (Minsky, 1986/2008) is a cornerstone of these activities. Short-term orientations become manifest in early investment payoff, often through management fees. Such payoffs are systematically privileged over long-run value creation (Erturk, Froud, Johal, Leaver, & Williams, 2010; Jackson & Petraki, 2011).

### 2.1. Financialized business models as temporary inter-organizational configurations

While the rise of finance has been observed by scholars of various disciplines (Dore, 2008; Epstein, 2005; Krippner, 2011;

Nölke, Heires, & Bieling, 2013; Stockhammer, 2010; van der Zwan, 2014), inter-organizational analyses, so far, have been less prominent. Mostly, financialization studies concern themselves with general transformations of socio-economic logics (Krippner, 2005) or with the rise of equity ownership and the orientation towards shareholder value (Boyer, 2000; Froud, Haslam, Johal, & Williams, 2000; Jürgens, Naumann, & Rupp, 2000). Establishing the primacy of financial management within a firm (Boyer, 2007, p. 795), aligning the firm’s operations with the demand of financiers through fair value accounting (Perry & Nölke, 2006) and changing CEO compensation (Jung & Dobbin, 2012) are relevant intra-organizational aspects of financialization. And yet, (re-)distribution of corporate surplus from stakeholders to shareholders through organizing, valuation and accounting is only slowly becoming part of the research agenda, which for a long time has predominantly been interested in the changing modes of investment and profit extraction. Therefore, in this paper, we go beyond these approaches by demonstrating the role of valuation and accounting practices in inter-organizational relations and by showing how they power financialized business models (cf. Zott & Amit, 2010).

Following Casadeus-Mansanell and Ricart (2010, p. 195) in that a business model “is a reflection of the firm’s realized strategy”, we understand it as a concept which defines an organization’s value-generating logic. While a business model, thus, represents “the logic of the firm, the way it operates and how it creates value for its stakeholders”, strategy, in turn, “refers to the choice of business model through which the firm will compete in the marketplace” (Casadeus-Mansanell and Ricart, 2010, p. 196). Business models therefore provide an analytical toolkit in order to understand how value creation is designed and organized (Teece, 2010).

We speak of *financialized* business models and focus on a particular subset of business models based upon and tailor-made to suit financial market logics. Financialized business models are designed to seek high returns quickly, thereby trumping other objectives such as long-term sustainability or customer satisfaction. In real estate, financialized business models are often associated with loan securitization (“originate-to-distribute”), which allows reducing debt on a lender’s balance sheet through passing on credit to third parties via financial instruments (Ashcraft & Schuermann, 2008; Purnanandam, 2011). These activities not only rid lenders of most of their obligations, they also generate immediate returns by selling financial instruments (Goldstein & Fligstein, 2014). In this context, management fees are used within inter-organizational relations to allow the transfer of capital (Sikka & Willmott, 2010) and are often paid up-front to settle commissioned services (cf. Malkiel, 2013).

As we will show in this paper, fees are constitutive for inter-organizational management in the real estate sector and are instrumental to bringing forward unrealized gains, mainly through up-front management and structuring fees. Therefore, to understand financialized business models and analyze financialization at the inter-organizational level, it is paramount to consider these payments as value carriers which are rooted in valuation and accounting practices.

### 2.2. Accounting as strategic inter-organizational practice

In her review essay, Chua (2007, p. 487) emphasizes that “accounting research has not always focused on the doing of accounting work” and argues for looking more closely at “the diverse activities associated with the creation, circulation, transformation and destruction of accounts.” More precisely, to understand the constitutive effects of varied forms of calculation, it is “important to pay attention to the diverse nature and constitutive effects of

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