

Fair Value and the Missing Correspondence Between Accounting and Auditing

AOS Workshop 'Financial reporting as social and organizational practice'

London School of Economics, 12–13 December 2011, London, UK

Kim K. Jeppesen*

Dennis van Liempd**

*) Department of Accounting and Auditing, Copenhagen Business School,
2000 Frederiksberg, Denmark
Email: kkj.acc@cbs.dk, Tel.: +45 38 15 23 06, Fax.: +45 38 15 23 21

**) Department of Entrepreneurship and Relationship Management, University of Southern
Denmark, 6000, Kolding, Denmark
E-mail: dvl@sam.sdu.dk, Tel: +45 65 50 14 69; Fax: +45 65 50 13 57

PLEASE DO NOT QUOTE WITHOUT PERMISSION

Abstract

There is a close, in many respects inseparable, relationship between accounting and auditing (Mautz and Sharaf, 1961). This paper argues that throughout history, whenever accounting's main paradigm changed, auditing changed with it. When IFRS in 2005 became mandatory for all listed companies in Europe, fair value as a concept finally seemed to have prevailed over the concepts of historical cost and stewardship. The purpose of this paper is to argue that this paradigm shift in accounting has not yet had the expected consequences for the main auditing paradigm.

Accounting's main paradigm for the first few millennia was about stewardship, i.e. the reporting of a steward to a principal for personal or fiscal accountability. The main audit paradigm was therefore one of checking truthfulness, i.e. the honesty and integrity of the steward, not the quality of the accounts. In the 18th century, accounting's main paradigm changed from this truthful reporting to reporting the truth, i.e. the positivist congruence between reports and some form of external reality. Auditing changed accordingly, in that verification of a steward's truthfulness slowly was replaced by verification of the truth, i.e. a "true and correct" view of this external (economic) reality. With the politicisation of accounting standard setting in the second half of the 20th century, accounting again changed from reporting the truth to reporting "in accordance with GAAP", i.e. a neo-positivist correspondence with established criteria. Auditing changed correspondingly, culminating in ASOBAC (AAA, 1973), which until today remains the fundamental conceptual framework on auditing. The ASOBAC framework defines auditing as "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users" (p.2).

For the past decade or two, accounting's main paradigm has changed again from the neo-positivist correspondence with criteria to a social construction of consensus, which can be seen in the change from the 1990s onwards to the fair value paradigm, culminating in the new IFRS 13 of May 2011 on Fair Value Measurement (IASB, 2011). Even though fair value seems to have established itself, the conceptual underpinnings of fair value have never really been justified theoretically (Bromwich, 2007). What is missing are discussions on reliably representing socially-constructed realities (Lee, 2006a), and the association between fair value and quality labels such as true and fair view and fair presentation (Lee, 1994). What is missing are also discussions about the implications of fair value, socially-constructed realities and reporting quality labels on the role of the auditor in giving an opinion on this fairness. This paper argues that auditing has not changed accordingly, remaining in the neo-positivist paradigm defined by ASOBAC.

This lack of research into the implications for auditing can be problematic, since, by definition, fair value augments the existing problem of accounting subjectivity, auditability and accountability (see also Power, 2010). This can for example be seen in the new IFRS 13, which specifies a fair value hierarchy of three levels, ranging from observable, quoted market prices in active markets, to unobservable, subjective guesses without markets or a desire to sell. This is not only a problem for preparers and users, but also very much for auditors, who have to issue an opinion based on these subjective future valuations open to manipulation by management (Zack, 2009) rather than on documented historical numbers. This missing correspondence between accounting and auditing's main paradigms can cause problems for both academics, standard-setters and practitioners. The paper will conclude with these implications and the need for future research.

1. Introduction

When IFRS in 2005 became mandatory for all listed companies in Europe, fair value as a concept finally seems to have prevailed over the concepts of historical cost and stewardship. Since there is a close, in many respects inseparable, relationship between accounting and auditing, the issue this paper addresses is that this paradigm shift in accounting has not had the expected consequences for the main auditing paradigm.

The close link between accounting and auditing is claimed by various classic auditing publications (e.g. Mautz and Sharaf, 1961; AAA, 1973). As Mautz and Sharaf point out though, the two disciplines are complementary, “like business associates, not like parent and child” (1961: 14). Accounting is defined by the American Accounting Association (AAA) in *A Statement on Basic Accounting Theory* (ASOBAT) as “the process of identifying, measuring, and communicating economic information to permit informed judgment and decisions by users of the information” (AAA, 1966: 1). Auditing, on the other hand, is defined by the AAA in *A Statement on Basic Auditing Concepts* (ASOBAC) (AAA, 1973: 2) as “a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users”. As ASOBAC uses the accounting definition provided in ASOBAT, accounting (the system, the process, and the information generated and communicated) is the subject matter of auditing.

Even though Mautz and Sharaf (1961) state that there also are important distinctions in terms of accounting and auditing’s objectives and typical methodologies used, this paper posits that the link between the two are so tight that changes in accounting’s main paradigm usually should lead to changes in auditing’s main paradigm. In other words, ontological, epistemological and methodological changes in the worldview in accounting have an influence on the ontological, epistemological and methodological worldview of auditing. If one changes, the other should change as well, in order to uphold a valid relationship between accounting (the subject matter) and auditing.

As this paper will argue, every time accounting’s paradigm changed, auditing thus changed along with it. From ancient times till the end of the 18th century, accounting’s main paradigm was about stewardship, with a corresponding main audit paradigm of checking truthfulness, i.e. the honesty and integrity of the steward, not the quality of the accounts. In the 18th century, accounting’s main paradigm changed to reporting the truth, i.e. the congruence of the financial statements with some form of external reality. Auditing changed accordingly, so its main focus became verification of the truth, i.e. a “true and correct” view of this external reality. With the politicisation of accounting standard setting in the second half of the 20th century, accounting again changed, now to reporting “in accordance with Generally Accepted Accounting Principles” (GAAP). Auditing changed correspondingly, which can be seen in auditing’s fundamental conceptual framework, ASOBAC (AAA, 1973), which defines auditing as checking “the degree of correspondence between assertions and established criteria”, i.e. GAAP.

The last decade or two, accounting’s main paradigm has changed to a fair value paradigm. This can for example be seen in the new IFRS 13 “Fair Value Measurement” of May 2011 (IASB, 2011). However, auditing has not changed accordingly. Even though fair value in accounting thus seems to have established itself, the conceptual underpinnings of fair value have never really been justified theoretically (Bromwich,

2007). As Lee (2008: 94) states, “accounting standard setters such as the FASB and the IASB do not appear to have been unduly aware of, influenced by, or interested in the large body of theoretical literature that had accumulated in the 1960s and 1970s on matters such as current valuation”. Van Zijl and Whittington (2006: 122) concur in that “fair value has entered certain accounting standards as a response to needs, on a standard-by standard basis rather than as a result of a formal amendment to conceptual frameworks, and without extensive academic discussion, such as that which preceded the introduction of deprival value”.

Even though a fair body of literature on fair value has arisen, most academic publications are not theoretical, but focus on fair value valuation’s efficacy and its influence on capital markets, following the mainstream quantitative paradigm (see e.g. sources in Linsmeier et al., 1998; Barth et al., 2001; Landsman, 2007). These studies generally find that investors perceive fair value estimates as more value relevant than historical cost figures (Barth and Landsman, 1995; Barth et al., 1996; 2001). When theoretical structures are used, most look at fair value through qualitative characteristics such as comparability, consistency and uniformity (e.g. Barlev and Haddad, 2007), usefulness, stewardship and informativeness, relevance and reliability (e.g. Landsman, 2007; Ronen, 2008), which Lee (2008) calls a “vague conceptual framework lens”. Traditionally, the historical cost paradigm favours reliability over relevance and applies conservatism, while the fair value paradigm favours relevance for usefulness in decision-making and downplays reliability. Power (2010) interprets the rise of fair value in terms of a contest between fundamentally different conceptions of reliability, where this reliability might be called a social construct. What Lee is missing are discussions on reliably representing socially-constructed realities (Lee, 2006a), and the association between fair value and quality labels such as true and fair view and fair presentation (Lee, 1994).

What also is missing are discussions about the implications of fair value, socially-constructed realities and reporting quality labels such as true and fair view on the role of the auditor in giving an opinion on this fairness. The *Routledge Companion to Fair Value* (Walton, 2007) for example had 20 chapters on fair value, with only one about auditing. This lack of research into the implications for auditing can be problematic, since the value to users of fair values depends critically on the trustworthiness and auditability of the measurements. By definition, the new IFRS 13 augments the existing problem of accounting subjectivity, auditability and accountability, because it specifies a fair value hierarchy of three levels, ranging from observable, quoted market prices in active markets, to unobservable, subjective guesses without markets or a desire to sell (cf. FASC, 2000; 2005; 2007). This is not only a problem for preparers and users, but also very much for auditors, who have to issue an opinion based on these subjective future valuations rather than on documented historical numbers. As Power (2010) states, fair value “is forcing traditional auditability values into a subsidiary position”. Guidance from audit standard setters with respect to fair value’s subjectivity and verifiability has also been requested by practitioners (Wilson and Ernst & Young, 2001).

The discussion about fair value accounting and auditing has intensified as the global financial crisis unfolds. The crisis has led to general discussions about the value of the audit function, including audit’s societal role, the scope of audit, and the suitability and adequacy of the current legislative framework (see e.g. House of Commons Treasury Committee, 2009; EC, 2010; ICAS, 2010; MARC, 2010). These generally show that users, preparers, and auditors would like to see less focus on costly, possibly non-value-adding, technical details and rules, and more focus on direct communication between stakeholders, more trust, and a broader, more holistic and consensus-based view on auditing. This is clearly a call for a different audit paradigm,

which to some degree is in accordance with Power's (1994) call for an alternative audit approach, more qualitative in nature and based on public dialogue rather than assessments by private experts. At the same time, the financial crisis has necessitated calls of attention to the audit problems caused by fair value accounting, in particular for financial instruments in markets that have become illiquid as a result of the crisis (IAASB, 2008) and potential manipulation by management (Zack, 2009). Thus, the crisis has triggered debates about the role of auditing and the way it relates to fair value accounting. These debates signal the existence of an ontological inconsistency between what constitutes reality in accounting and auditing, or at least an epistemological inconsistency between what preparers of financial statements and auditors perceive of as reality.

We claim that the missing correspondence between accounting and auditing has come about because auditing's basic philosophical assumptions has not been developed as much as its counterparts in the field of accounting. While fair value accounting represents a socially constructed reality, auditing still seems to be founded in the positivist tradition of evidence theory (e.g. Mautz & Sharaf, 1961; AAA, 1973; Flint, 1988). The remainder of the paper will analyze the missing correspondence between accounting and auditing. Firstly, the next section will shortly describe the methodology used for the analysis. Section three will give a brief overview of the historical change in the main accounting paradigm from reporting the truth to reporting in accordance with GAAP and the corresponding changes in the main auditing paradigm from ancient times until modern auditing in the nineteenth century, culminating in ASOBAC. In section four, the developments of the last decade or two are analyzed, more specifically the change in accounting's focus from correspondence with criteria to the social construction of consensus, which can be seen in the change in accounting from the 1990s onwards to the fair value paradigm. It will be argued that auditing has not changed accordingly, and that this missing link between accounting and auditing's ontological focus can cause problems for academics, standard-setters and practitioners. The paper will conclude with these implications and the need for future research.

2. Methodology

As argued in the introduction, the paper aims to establish the correspondence between accounting and auditing thought over time and is thus a conceptual, historical paper. In seeking to establish this correspondence, the paper does not assume that the history of fair value accounting is an evolutionary history of progress (Napier, 2001). On the contrary, we argue that fair value accounting is yet another example of the recurring issues in accounting and auditing discussed by Chandler & Edwards (1996). As such, the paper belongs to the "new accounting history" tradition (Miller et al., 1991), in which interpretation and theory development is seen as more important than descriptive histories based on extensive factual material. We consequently do not seek or claim our sources to be exhaustive, but we do claim these to be representative of accounting and auditing thought at the time. Similarly, we do not seek or claim to do a universal history of fair value accounting. Even though this can lead to a cultural bias (Carmona, 2004), the analysis of modern auditing is mostly confined to Anglo-American developments, since we perceive these countries as leading the development of accounting thought in the late 19th and the 20th century.

Although primary sources like laws and standards are included, the paper uses mostly secondary sources, as a means to analyse historical events. The reliance on secondary sources is to some degree necessitated by the nature of the study; historical accounting thought can hardly be studied in other ways. The danger of this approach is that the analysis becomes an interpretation of an interpretation. We seek to counter this risk by exposing our research to peers at an early stage.

Theoretically, the paper is informed by Habermas' critical theory. The potential of critical theory, and particularly Habermas, for understanding and changing accounting has been argued before (Laughlin, 1987; Arrington and Puxty, 1991), in that Habermas uses a more complete rationality concept, incorporating three worlds of reality, which are necessary to understand any phenomenon under investigation. Here, accounting and auditing reports can be seen as "symbolically mediated interaction" (Habermas, 1984) or speech acts. A smoothly functioning speech act, like for example between companies, their auditors, and the users of audit reports, rests on a background consensus formed from the mutual recognition of at least three different types of validity claims (*Geltungsansprüche*)¹: claims that the speech act's propositional content is *true* (truth claim), that the speaker is *sincere* in uttering it (truthfulness claim), and that it is *right or appropriate* for the speaker to be performing the speech act (rightness claim) (McCarthy, 1976/1997). Company's and/or their auditors thus make validity claims about the objective technical world (for example about the existence of assets), about the norms underlying the speech act in the inter-subjective, cultural world (e.g. the use of accounting and auditing principles, norms or standards), and about the truthfulness of these reports in the subjective world (are managers reporting fraudulent or sincere?). These so-called validity claims in each speech act can be criticized by others (e.g. auditors, users, or regulators), which forces the accounting party to ground or validate its validity claim by giving reasons if the validity claims are to be accepted as rational. This process of discourse aims to come to some form of consensus allowing the force of the better argument to prevail (Habermas, 1990). Accounting and auditing have historically focused on one or two, but never all three validity claims.

Even though Habermas' grand social theory was meant to be used at the level of society and total systems, its thinking can be used advantageously at more micro levels (Laughlin, 1987). In tune with middle-range thinking (Laughlin, 1995), Habermas' framework has been used as a guide for investigation and framing discussion (Broadbent and Laughlin, 1997), as we intend to do here. His communicative theory on validity claims in speech acts and ideal speech situations will thus be used as a heuristic, providing a structure and language, which will not restrict available understandings of specific issues. Since Habermas' work is huge and complex, we only extract what is needed for this understanding of changes in accounting and auditing's main paradigms, with all the dangers this appropriation of a grand theory entails.

3. From Positivist Truth to Neo-positivist in Accordance with Criteria

Accounting and auditing go back a long time in the history of humankind, practiced in almost every civilization involving economic activity (Brown, 1905/1968; Stone, 1969; Chatfield, 1974). In general, the higher the level of civilization, the more advanced the accounting methods; and with it developed some kind of account verification, or auditing. As Boyd (1905/1968: 74) says: "Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another, the advisability of some kind of check upon the fidelity of the former would become apparent".

3.1 Positivist Truth: Stewardship and the Honesty of the Agent

Van Liempd and Zachariassen (2011) argue from a Habermasian framework that there are macro-trends detectable in the history of auditing, which are relative to developments in accounting. Accounting in ancient times did not focus as much on the keeping of accounting records for external use, as on the reporting of stewardship for fiscal accountability for example. Auditing's role in ancient times, from the Egyptian pharaohs (Stone, 1969), the Greek polis (Costouros, 1978) and the Roman Empire (Boyd, 1905/1968) through medieval manorial and exchequer audits (Jones, 2008), was thus mainly to check the *truthfulness* of audit validity claims, i.e. the truth and authenticity of the verbal and/or written accounts of the agent. These ancient audits were mostly master-servant audits of familial or governmental units. The objective was to check the honesty and integrity of the steward in charge of the property of a principal (a *pater familias* or a king for example), not the quality of the accounts, i.e. the congruence with an external reality, or the compliance with norms and standards. The detection of fraud was therefore the foremost objective in these ancient audits, which was done by detailed verification of *every* transaction (Stone, 1969).

Accounting slowly changed in the Middle-Ages, focusing more on written records. According to Mills (1994), improved accounting techniques were made possible by the "advent of cheap business arithmetic and grammar made possible by the invention of the moveable type printing" (Mills, 1994: 81). The double-entry bookkeeping system was first written down in 1494 (Pacioli, 1494/1924). Slowly the auditory process of hearing the agent's accounts of stewardship was then also being replaced by visually scrutinizing these written records and testing entries by documentary evidence (Littleton, 1966: 265). Merchants of Florence, Genoa and Venice, for example, used audits to verify the accounts of their ship captains (Mills, 1994), while the City of Pisa was "designed to test the accounts of the governmental officials to determine whether defalcation had taken place" (Brown, 1962: 697). Profit-and-loss statements and balance sheets first appeared around 1600 (Littleton, 1966). The main focus throughout the early modern forms of bankruptcy audits (Chatfield, 1974) and railroad audits (Kitchen, 1982) in the seventeenth, eighteenth and nineteenth century remained on the validity claim of truthfulness though, i.e. the detection of fraud.

With roots in the ancient audit, the primary goal of British auditing in the nineteenth century was also verification of management stewardship (Chatfield, 1974: 111-124). Since stewardship was the focus of the audit, audit techniques generally consisted of a careful and complete check of the bookkeeper's work in order to detect management fraud in the form of misappropriation of assets. But this focus of the audit slowly changed from checking the validity claim of truthfulness to checking the validity claim of *truth*, i.e. some form of correspondence to an external (economic) reality. The result of the "detailed audit" was an audit opinion that the balance sheets "exhibits a true and correct view of the state of the company's affairs" (Toba, 1975: 12). The audit focus was thus on the balance sheet, with little or no audit of the profit and loss statement. In accordance with common practice, the British Companies Act of 1900 required audited balance sheets only.

With the focus on the balance sheet, guidance on asset valuation became an important task. However, the accounting profession was still relatively weak and not able to standardize behaviour or to resist managerial pressures. Asset valuation thus developed according to the needs of management, which meant that it varied a great deal between industries, within a given industry, and from place to place. Generally, management had a preference for income smoothing and equalizing dividend payments, which

called for valuations to support this. The period around 1900 is in the main characterized by conservatism: i.e. valuation at the lowest of historical cost or market value. The conservatism in valuation was supported by auditors, who preferred understated values to protect against unexpected business failures (Chatfield, 1974: 231-253). In spite of this, the auditor's responsibility for verifying the reported values of assets was the subject of debate following a number of controversial cases at the time (Chandler & Edwards, 1996) and there appear to have been different views as to what would constitute an adequate audit. Since the professional bodies did not respond to calls for issuance of authoritative statements, case law became highly influential in defining the British audit (Chandler, 1997).

3.2 Positivist Truth: Correspondence of the Financial Statements with External Reality

Differing from the British detailed audit, the American audit was not focused on stewardship. With banks playing a more prominent role in financing business than in Britain, bankers' need for financial information was at the heart of the development of American auditing. Relatively early, the audit focus was thus on the balance sheet, but not with the primary purpose of detecting management fraud. Instead, bankers' interest in liquidity made the American auditors focus on verifying current assets and current liabilities with little attention to the mechanical details of bookkeeping (Chatfield, 1974: 125-144). A typical American audit opinion of this time stated "we have examined all his books and accounts and found them correct in every particular" (Toba, 1975: 12). As a result of companies becoming relatively larger and more complex in the beginning of the 20th century, management gradually started to establish a system of internal control to safeguard assets and maintain reliable accounting records. With the larger companies the detailed audit became too expensive and auditors started to rely partly on testing the internal controls, partly on detailed verification (Chatfield, 1974: 128). The testing of internal controls was conducted as block tests, i.e. compliance tests of a part of the period under audit. Representative statistical sampling only became common in the 1950s, and with this it became legitimate to use sampling for substantive testing of account balances (Elliott & Jacobson, 1987; Power, 1992). As a result of the selective examination of balances and reliance on tests of controls in American auditing, audit opinions with references to "true and correct" accounts were considered inappropriate and even dangerous in the American context, where it could convey a false sense of completeness and exactness, and eventually cause liability problems for auditors. In the late 1920s, the common audit opinion was thus reworded to "true and fair". As the American stock market grew in the 1920s, the users of financial reporting increasingly included shareholders, who were more interested in earnings than in assets. Income statements thus became more important and included in the financial statements, and thus, on a selective basis, also an objective of the audit.

The ontological and epistemological assumptions behind mainstream accounting thought in the first half of the 20th century is thus that there exists an economic reality for a company, a reality which can be recognized by accountants and represented neutrally and objectively by means of financial statements (Chua, 1986; Macintosh, 2009). Ideally, accounting principles should therefore be apolitical and neutral and in order to ensure that the financial statements are neutral representations of reality. Accounting should, with a cartographic analogy sometimes used, be "financial map-making", in which the cartographer's subjective preferences are disregarded (Solomons, 1978; Ruland, 1984). Such neutrality can only be ensured when all parties involved in the development of accounting rules recognize the existence of a financial "landscape", from which a map may be drawn and refrain from giving this map a subjective character, although they might have a financial interest in it (Solomons, 1978). The way to achieve this

neutrality is through a broad consensus among all stakeholders that financial accounting's objective is to describe a company's economic reality. If financial accounting is perceived as a neutral, objective representation of economic reality, auditing's role is to verify that the financial statements are in accordance with reality. This was typically the perception of auditing's role in first half of the twentieth century. Writing from a British perspective, Dicksee (1933: 1) for example defines auditing as:

"..an examination of accounting records undertaken with a view to establishing whether they correctly and completely reflect the transactions to which they purport to relate".

Mautz and Sharaf (1961: 84) also agree that truth in auditing may be defined as "conformity with reality" as the auditor can determine reality at the time of his examination and with the evidence available. The financial statements are consequently a summary of the underlying transactions, in which each item must be accurate and complete. Auditing's role is to verify that this is the case, whether through a detailed audit of all transactions or through sampling.

3.3 Neo-positivist "In Accordance with Criteria"

Briloff (1964) and Flint (1971) note that during the late 19th and early 20th century, social change in Britain and America increased the size and complexity of business units and gradually introduced a class of professional managers with little or no stake in capital. To assess the performance of this management class, the traditional stewardship audit with its focus on the balance sheet was less suitable. Gradually profit and loss accounts therefore became the yardstick by which to measure management's performance, although profit and loss accounts were only required by law as from 1929 in Britain. However, even more than the balance sheet, the profit and loss account was open to the opinion and judgment of management, causing problems with the "true and correct" audit opinion. The foundation for the audit was thus also altered and the stewardship audit gradually became obsolete. In the second half of the nineteenth century, British and American accounting struggled to professionalise, and in this process, auditing expertise was central for the recognition of their jurisdiction (Chandler & Edwards, 1996; Maltby, 1999; Walker, 2004). In the attempt to professionalise, auditors wanted to raise the status of the required knowledge by deemphasizing the routine verification procedures and upgrade the analysis of judgmental errors. After 1900, sampling and tests of internal controls thus became more common (Chandler & Edwards, 1996), allowing audit emphasis to shift from the detection of fraud and clerical errors toward scrutiny of reporting fairness. Consequently, auditors were increasingly forced to elaborate on the norms of proper accounting treatment in the form of development of general accounting principles. Since principles by nature allow a certain spread of practice (otherwise they would be narrow rules), the audit opinion changed to "true and fair" and turned auditors into judges of validity claims of fairness according to a public interest perspective.

The role of auditing as verifier of the truth of financial statements came thus under pressure relatively early. In 1933, the New York Stock Exchange required listed companies to publish audited financial statements, but they were free to choose their accounting methods within the framework of "accepted accounting principles" provided they disclosed the methods chosen and used them consistently. As a consequence of this, the validity claim of truth (correspondence with an external reality) was deemphasized, and the auditor's report was reworded making accounting principles the criteria for

measuring reporting fairness (Chatfield, 1974: 132-133). As in Britain, the accounting profession was assumed to play a leading role in the codification of such principles.

From the mid-1960s, the American Accounting Principles Board was routinely being lobbied by a diverse range of parties, including corporate managements and auditors acting in the interests of these (Zeff, 1978; 2003a; Moonitz, 1974; Watts & Zimmerman, 1978). Horngren (1973: 61) thus noted that “standard setting is as much a product of political action as of flawless logic or empirical findings”, the consequence of which being that the process of setting accounting standards should be aimed at persuading the affected parties that the standards were acceptable. The accounting standard setting process had become openly political, and it became increasingly legitimate to consider the economic consequences for specific groups when developing GAAP (Zeff, 1978; Ruland, 1984). Proponents of this politicization of accounting, for example Gerboth (1972; 1973), pointed out that in a democratically committed society, only open and responsive political institutions are entitled to demand others to follow their rules. The process by which accounting standards are developed should therefore be political to be just, i.e. it should be responsive to change in the community of subjects (McKernan, 2007: 174). However, the politicization of accounting made the standard-setting process open to lobbying (Sutton, 1984; Kenny & Larson, 1993) or the exercise of other types of power (Fogarty et al., 1994), thereby giving wealthy or otherwise powerful groups an advantageous position. Thus, with the politicization of accounting, standard-setting bodies’ main challenge became to reconcile the conflicting economic interests of the preparers of financial statements (Zeff, 1978), while leaving the users of financial statements with the impression that the standard setting process is an objective search for the best possible solution (Young & Mouck, 1996).

In the political perspective on accounting, there still appears to be a perception that an objective economic reality exists for a company, but there are competing perceptions of how this reality should be represented in the financial statements. Accounting principles are thus products of political compromise. The more interests involved in a specific area, the more difficult it becomes to make precise and hard accounting standards that limit behaviour in the area. In key areas, accounting principles therefore apply extensive discretionary options, or use “soft” interpretable concepts (Masocha & Weetman, 2007; Jeppesen, 2010). This allows a range of conflicting interests to be reconciled, but the price is that economic reality cannot be represented in the financial statements in an unambiguous manner. The politicization of accounting was problematic for auditing, because it meant that a company’s economic reality could be interpreted and reported in several different, but equally valid ways. The consequence of this was that auditing no longer could verify that the accounts were in accordance with reality. If auditing as an institution was to survive the politicization of accounting, it needed to be redefined according to the new ontological and epistemological perception of accounting. The redefinition of auditing was formally done in 1973 (although with roots back to 1933), when the AAA published ASOBAC. In this conceptual work auditing was defined as follows:

“Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users” (AAA, 1973: 18).

With this definition, auditing is no longer verification of the financial statements’ representation of reality (the truth), but verification of whether the accounts are prepared in accordance with established criteria

(rightness), on which the auditors may have a varying degree of influence. The definition is solidly founded in philosophical presuppositions, one of the most important being that it no longer necessitates a belief in epistemological objectivity (Shapiro, 1997: 174).

Thus, we argue that the objective of auditing has changed because of a change in the ontology and epistemology of accounting, i.e. in the way accountants think accounts could and should represent economic reality. In its origin, verbal or written accounts were perceived of as representations of truth or reality, and auditing was consequently about verifying the truth of these accounts. The underlying conceptual paradigm is an ontology based on philosophical realism and an epistemology based on positivism or objectivity. In this perspective, accountants believe in the existence of an objective economic reality for a company, which may be recognized independently of the subject. Thus, the premise for the development of accounting principles is to find the right or correct way to represent economic reality in the financial statements, as argued by Solomons (1978; 1983; 1991; 1995). However, the gradual politicization of accounting, in which managements' vested interests in accounting became a legitimate concern, changed the epistemological foundation in a neo-positivist direction. With the rise of "economic consequences" in accounting standard setting (Zeff, 1978), economic reality could be represented in financial statements in a number of equally valid ways, and accounting standards therefore generally started to allow a higher degree of variation in practice, either by exceptions to rules in rules-based standards or by a turn to principles-based standards (Benston et al., 2006). As a consequence, auditing's role as the verifier of truth in accounting consequently had to change into checking correspondence with established criteria.

However, there were critics of this development. Briloff (1964) warned that the American economy over the first half of the 20th century transformed from a 'democracy' into a 'republic', where power and responsibility was delegated from shareholders to professional management. In this process, the accounting profession had become too involved with professional management, giving them influence (and advice) on the accounting principles on which management would be judged. With this influence, management was in control of the criteria auditors used to evaluate them against, and this was perceived to be a problem in relation to the auditors' responsibility towards the users of financial statements. Briloff (1964; 1966a; 1966b) considered the historical cost accounting regime responsible for this, because it allowed management to choose from alternative practices, which could produce materially different results, while the public had the impression that the attesting auditor selected the practices. Accounting practices had thus become too far from objective reality resulting in a "gap in GAAP" (Briloff, 1966a). The gap was publicly visible and debated following a number of accounting scandals, and the theory behind it, or more generally "accounting thought", was by some considered as being in crisis (Wells, 1976: 475). Briloff (1964) consequently argued for a revolution of accounting, in which a turn to fair value accounting was a central issue because this would "limit the effectiveness of managerial determination in changing the reported operating results" (Briloff, 1964: 14). Thus, fair value accounting was considered a potential means for auditors to regain control over the audit criteria. As we will argue in the next section, this was only partially successful.

4. From Neo-Positivist Criteria to Social Construction of Consensus

We have seen that financial accounting presupposed a positivist correspondence theory of truth (McKernan, 2007), where a financial representation is true if it corresponds (at least approximately) to the underlying economic reality that it purports to represent (Shapiro, 1997). This interpretation of truth as correspondence to facts is built on a notion of an objective external reality (external realism) (Alexander & Archer, 2003). Hines (1991) demonstrates that this is just “commonsense reasoning to sustain incorrigible propositions about an objective world and assists the status-quo”, while stopping change. Hines (1988) suggests a social-constructivist view on reality. There are different form of social-constructivism; Alexander and Archer (2003), Mouck (2004) and Lee (2006a; 2006b) for example base their notion of reality on Searle’s (1995) socially constructed reality (internal realism). They claim that accountants deal with social rather than brute facts. Brute facts are defined as physical facts explainable in terms of science, whose existence is intrinsic, i.e. independent of humans (external realism). Social facts, on the other hand, exist because humans mentally assign a function to them. When enough humans collectively share this meaning, institutional facts arise. Although many accounting objects are comprised of physical particles, it is thus their social function in economic activity that is the subject of representation (Lee, 2006a). Here, we follow this non-radical form of social-constructivism, which focuses on the construction, through the interplay of actors, of institutions, knowledge, methodologies, fields, habits and regulative ideals (Sismondo, 1993).

In this section 4, we will first outline the historical development of asset valuation, particularly focusing on current values and other predecessors of fair value. Then we turn to analyze the new fair value paradigm according to IFRS 13, as a result of which we argue that we are experiencing a change from a neo-positivist to a social-constructivist paradigm in accounting thought. We finally argue that this paradigm change in accounting is not matched by a corresponding change in the main auditing paradigm.

4.1 Evolution of the Fair Value Paradigm

As Lee (2008: 95) states, it is easy to get the impression that fair value is a “recent and more objective” addition to practice, but in reality fair value is not novel. Richard (2004) describes how France already used some kind of fair value throughout the 1800s. The 1807 Commercial Code (which was based on the 1672 *Savary Ordonnance*) for example required businesses to draw up an annual inventory of assets and liabilities at their value on the day of inventory (market value). This market value was in practice often considered a liquidation value, which also could include potential gains, or a lower of cost or market (Richard, 2004: 99f). The same goes for Germany (Moxter, 1982), where a balance sheet had to show “*der augenblickliche Wert des Vermögens*” (Simon, 1899: 303), i.e. the immediate or current value of the assets. When Germany started to move away from liquidation values to a going-concern principle, Simon showed to be truly before his time, when he advocated a company-specific (i.e. not market-determined) value in use (*Gebrauchswert*), which was based on the future income expected to be generated by the assets (Simon, 1899: 366). As stated before, we will though here focus on developments in the UK and USA, as present standard-setting originates in the accounting traditions of these countries.

In the UK, fair value in the form of ‘selling prices’ and ‘the then fair estimated value’ was used in the 1820s and 1830s, mostly in bank deeds (Chambers and Wolnizer, 1991). The first Joint Stock Company Acts of 1844, 1845, 1856 took an implicit going concern view in requiring a ‘true and correct’ view, in that assets had to be given at “up-to-date prices, and specifically at selling prices in the ordinary course of business”

(Chambers and Wolnizer, 1991: 197). The company acts, however, did not detail valuation and measurement rules, which gave considerable flexibility and freedom (Brief, 1966). Most non-public enterprises used an inventory method of valuing assets and defined profit as the change in value of net assets in two successive periods (Brief, 1966).

In the USA, asset valuation practices also appear to have been rather heterogeneous in the latter part of the nineteenth century as the period is devoid of accounting theory on the subject (Storey, 1959). Chatfield (1974) discusses how the use of replacement cost valuation for fixed assets developed between 1870 and 1900. In this period, the general price level was falling, which generally led to overvalued assets when using historical cost, as well as problems calculating utility rates (Boer, 1966). This possibility for overstatements gave managements a benefit, while causing problems for auditors and users of financial statements. To protect against more or less deliberate misuse of asset valuations the accounting profession promoted conservatism as the dominant accounting principle: assets should be valued at the lower of cost or market value.

By 1900, conservatism was recommended by most authorities in the UK and USA. The lack of asset valuation theory was remedied when Dicksee in 1892 introduced the going concern principle, which became generally accepted in the first decades of the twentieth century (Storey, 1959; Chatfield, 1974). The general idea of the going concern principle ruled out the use of liquidation prices in valuing assets. According to the going concern principle, fixed assets should be valued at historical cost and depreciated over their useful life, while current assets should be valued at net realizable value. However, the use of net realizable value for current assets went against the average accountants' conservative creed of "anticipate and provide for all losses, but never anticipate a profit" (Storey, 1959), and in the decade after the First World War the realization rule was superimposed on the going concern principle to avoid carrying the going concern assumption to its logical conclusion (Storey, 1959; Chatfield, 1974). The realization rule required all unrealized assets, fixed as well as current, to be valued at cost (Storey, 1959). In the USA, the use of the realization rule was further advanced by the passing of the Revenue Act in 1913, following which company profits (income) was taxed and taxation consequently became part of the ordinary accountants' work. In calculating the taxable profits the use of net realizable value was considered problematic, since it would result in the creation of unrealized taxable profits. The application of the realization rule, on the other hand, defined profits as the difference between the selling price of an asset and its cost, with the consequence that only realized profits were taxed.

However, the development of accounting theory was also affected by changes in the price level (Boer, 1966). From around 1900 onwards the general price level started to increase, reversing the general problem to become one of undervalued assets. In this situation, the use of "lower of cost and market value" created an increased margin between the current value and the book value of assets, giving the auditors further incentives to promote the realization principle. Management, on the other hand, was adversely affected by the developments. Although income tax gave management an interest in supporting the realization principle, inflation generally made management more interested in using current values to show the real value of their companies.

However, US inflation temporarily ceased with the stock market crash in 1929. The crash led to a falling price level in the US in the early 1930s, which caused concern among accountants about conservative asset valuation practices, but also led to a widespread realisation that stock prices depended more on a

company's earning power than on the value of its assets (Chatfield, 1974). The primacy to earning power led to more focus on income determination through the matching of costs and related revenues (AAA, 1936), which weakened the influence of conservatism in accounting. Accordingly, the first US attempts to codify accounting theory stressed the matching concept and historical cost as the stable basis for income measurement (Chatfield, 1974). The period after the Great Depression is consequently characterised by a general move away from the use of current values and towards historical cost for fixed assets (Swieringa, 2011). This move was supported by the then newly formed SEC, which considered some of the current value based asset write-ups to be arbitrary (Swieringa, 2011).

Although practice was moving towards historical cost in the 1930s, accounting theory challenged this development from the perspective of the users of financial statements. Rorem (1929) was a proponent of market value, either in the form of replacement cost or net-sales price, while assets intended for use should be valued by reference to the present value of their future services. Other individual proposals based explicitly on fair market values were economist John Canning in his book *The Economics of Accountancy* (Canning, 1929/1978)², which built a whole conceptual valuation framework based on future expectations, and Kenneth MacNeal, who in his *Truth in Accounting* also focused on economic, market-based values: "the price at which it is actually being bought and sold" (MacNeal, 1939: 87). MacNeal's market prices were not forward looking though, since he felt accountants "should not act as a prophet"³. Paton and Littleton's monograph (1940) had some elements of futurity in accepting current values and price levels in supplementary reports, and Alexander's monograph (1950) also attacked historical cost accounting, stating that changes in capitalizations of expected future earnings of a business entity constitute economic income (corrected for changed money values).

The theoretical contributions combined with the re-emergence of inflation in the US after the Second World War⁴ led to a renewed discussion among accountants about the use of historical cost, replacement cost, or current values as the foundation for asset valuation (Carson, 1949). However, it was not until the 1960s that the 'classic' arguments for market value were published. Edwards and Bell (1961) distinguish different value concepts according to the form and place of the thing being valued, the date of the price used in valuation, and the market from which the price is obtained. They thus distinguish between initial inputs, present form, and ultimate form, past, current, and future prices, and entry and exit prices. Alexander (2007) adds to this the distinction between ultimate form-as-disposal and value-in-use, yielding a matrix with 24 value concepts. If fair value is not well-defined, it may thus take the form of an entry price (replacement cost), net realizable value, value-in-use, or deprival value (Schipper, 2003). There seems to be a tendency though to use the term fair value as a loose term for market or current value (Alexander, 2007).

The appearance of Edwards and Bell (1961), various publications by Chambers (e.g. 1962; 1966; 1968), Moonitz (1961/1982), Sprouse and Moonitz (1962/1982) and Sterling (1967; 1970; 1972) had thus marked an awakening of accounting academics to the deficiencies of historical cost accounting, most advocating the use of current market values, adjusted for changes in money value⁵. High inflation rates in the late 1970s and early 1980s⁶ kept the debates on inflation accounting going and the form of current value that found its way into actual or proposed accounting standards at that time was current cost derived from the deprival value model (van Zijl and Whittington, 2006). This approach collapsed in the mid-1980s as a result of declining inflation rates and the scepticism of preparers of accounts about the efficacy of current cost accounting (Tweedie and Whittington, 1997). Pong and Whittington (1996) explain further that the lack of

economic incentives (e.g. disallowing current cost for taxation purposes), other environmental factors (e.g. the lack of confidence by the ICAEW) as well as the difficulty in applying the standard and understanding its results also played a role. Although deprival value thus fell out of favour with standard-setters, it remained a feature of the *Statement of Principles* of the UK Accounting Standards Board (ASB, 1999) in the form of Value to the Business.

Although US inflation has been relatively low since the mid 1980s, the wealth of literature on current cost and current value accounting gave legitimacy to market values, which slowly were incorporated into the US Financial Accounting Standards Board's (FASB) standard setting process (Georgiou and Jack, 2011). Fair value was first defined by the FASB in 1976 in Financial Accounting Standard (FAS) 13 "*Accounting for Leases*" as "the price for which property could be sold in an arm's-length transaction between unrelated parties" (para. 5c). The International Accounting Steering Committee (IASC) first mentioned fair value in International Accounting Standards (IAS) 17 "*Accounting for Leases*" in 1982. In December 1984, the FASB issued Statement of Financial Accounting Concept (SFAC) No. 5 "*Recognition and Measurement in Financial Statements of Business Enterprises*", which identified the use of five measurement attributes: historical cost, current cost, current value, net realizable value and present value. The last three of those attributes are consistent with fair value measurement concepts and thus provided a theoretical framework for further moves towards fair value accounting, which took place over the following years through a series of FASB pronouncements.

In the 1990s and early 2000s, culminating with the application of IFRS in 2005, a mixture of fair value and value in use assuming a valuation of companies based on their future profitability came to the forefront. In the US Financial Accounting Standards No. 133 (FAS 133) "*Accounting for Derivative Instruments and Hedging Activities*" was issued in June 1998, defining fair value as "the amount at which an asset could be bought or sold in a current transaction between willing parties; that is, other than in a forced or liquidation sale". This definition makes no distinction between entry and exit prices. In FAS 107 (1991), the FASB expanded the term to include "market prices" and estimates of market prices based on the present value of estimated future cash flows, on option-pricing models, etc. From then on fair value was referred to at an increasing pace in FAS-s, e.g. FAS 116 (1993) and FAS 125 (1996). The FASB published SFAC No.7 "*Using Cash Flow Information and Present Value Accounting Measurements*" in 2000, stating that "to provide relevant information in financial reporting, present value must represent some observable measurement attribute of assets or liabilities. In the absence of observed transaction prices, accounting measurements at initial recognition and fresh-start measurement should attempt to capture the elements that taken together would compromise a market price if one existed, that is, fair value." In June 2001, FAS 142 "*Goodwill and Other Intangible Assets*" required goodwill to be annually tested for impairment with reference to fair value. In September 2006, FAS 157 "*Fair Value Measurements*" redefined fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". It is also explicit in defining fair value as an exit price. Fair value guidance was still dispersed though among many pronouncements with limited guidance on their application within the GAAP framework. The UK showed a mixed historical cost and current value system in the 1990s, e.g. in FRS 15 "*Tangible Fixed Assets*" (ASB, 1999), where the ASB permitted the choice for tangible fixed assets. Also in its Conceptual Framework project, the ASB showed a gradual evolution from historical cost to one in which assets and liabilities are stated at "value to the business" (ASB, 1999).

Internationally, the IASC paid close attention to the relevant US accounting standards, and the references to fair value. The paragraphs in the IASC Framework (IASC, 1989) up to paragraph 98 implicitly point to a fair value system, but the world did not seem ready for fair value in the 1980s (Georgiou and Jack, 2011). Thus, from paragraph 99 and onwards historical cost, current cost, realizable value, and present value are mentioned, with historical cost remaining the most used valuation base (para.101). Since then, the IASC moved to fair value measurement in its different standards. The IASC was replaced by the IASB in 2001 and the new board adopted the existing IAS, while developing new IFRS. The EU adopted IFRS for all listed companies from the year 2005. However, since guidance on fair value measurement was “dispersed across many IFRSs”, was “not consistent”, provided “neither a clear measurement objective nor a robust measurement framework” (IASB, 2009), the IASB developed IFRS 13 on fair value measurement, which was finally adopted in May 2011. The Board’s objectives were to establish a single source of guidance for all fair value measurements as to reduce complexity and improve consistency, to clarify the IASB’s fair value definition as to communicate the measurement objective more clearly, and to enhance fair value disclosures (IASB, 2009: 5).

In summary, asset valuation has been a central issue in accounting practice and theory since the latter part of the nineteenth century. The competition between the historical cost principle and various forms of current value has been much more than a technical accounting issue, with the proponents of each principle having vested interests in the accounting principle applied. The general price level has had a direct influence on the perceived interests; in periods of declining inflation public accountants have favoured conservatism in the form of “lower of cost and market value”, while management has favoured historical cost. Conversely, in periods of high inflation public accountants have favoured historical cost, while management has generally favoured current values. The fear among accountants that current values were open to manipulation by management was a central concern behind the initial support of historical cost.

However, with the politicization of accounting in the 1960s, managements’ influence on accounting standards was on the rise causing increased heterogeneity of practice. As discussed in section 3, some accountants considered the historical cost regime as the cause of this and started to argue for a turn to fair value accounting to limit management’s discretion (Briloff, 1964). On the other hand, Laux and Leuz (2009) have shown that banks consistently have argued against fair value and claimed that it contributes to the financial crisis and exacerbates its severity. Another motive could be that fair value allows banks to choose when to realize gains, and offers more discretion to management, for example with regard to impairment. Today, Power (2010) still considers fair value accounting’s perceived potential to minimise management’s freedom to manipulate accounting numbers as one of the main motivations behind fair value accounting’s recent momentum.

However, the promulgation of fair value accounting has apparently not empowered auditors. On the contrary, Power (Ibid: 206) notes that the control of the audit criteria now rests with the accounting standard-setters in the IASB, which gives auditing standard setters in IAASB little influence. At the same time, these standard-setters have become more autonomous and dominated by intellectuals heavily influenced by financial economics. Power (2010) argues that these proponents of fair value were increasingly intolerant of mixed measurement systems. He interprets the rise of fair value in terms of a contest between fundamentally different conceptions of accounting reliability, which he calls a social

construct (ibid: 198). The IFRS 13 is a product of this history and this line of thought, and will be analyzed in the next section.

4.2 Fair Value Standards and the Social Construction of Consensus

This new IFRS 13 on fair value measurement does not require additional fair value measurements, but collects dispersed pronouncements on fair value in one standard. Fair value in IFRS 13 is defined as “the *price* that would be received to sell an *asset* or paid to transfer a liability in an *orderly transaction* between *market participants* at the measurement date” (IASB, 2011: para.9); own italicization⁷.

This exit price definition consists of many elements (italicized in the definition), which of course in themselves have to be defined and explained. These further definitions and explanations incorporate subjective moments and choices, such as: (1) the particular asset that is the subject of the measurement; (2) for an asset, the valuation premise that is appropriate for the measurement (consistently with its highest and best use); (3) the most advantageous market for the asset; and (4) the valuation technique(s) appropriate for the measurement, considering the availability of data with which to develop inputs that represent the assumptions that market participants would use in pricing the asset and the level of the fair value hierarchy within which the inputs are categorized.

As the IASB states, a fair value measurement thus requires firstly for an entity to determine the particular *asset* that is the subject of the measurement (consistently with its unit of account). Measurement shall therefore, according to IFRS 13 para. 11, consider the characteristics of the asset or liability (i.e. the condition, location, restrictions and so on), if market participants would consider those characteristics when determining the price. The definition thus assumes not only that company managers consider the condition, location, restrictions and so on of their assets, but also that a manager can know which of these characteristics a market participant would consider in determining the price. Epistemologically, this is a move away from either positivist correspondence with an external reality or neo-positivist correspondence with criteria in the transactions-based model, to a constructivist view of reality or realities in a market-based or market-simulating process. This has consequences for auditing, since an auditor, in turn, has to determine that those characteristics chosen by management are those a market participant would consider, thereby participating in a social construction of this reality.

Secondly, the asset is assumed to be exchanged in an *orderly transaction*, which is defined as

“a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets ...” (IASB, 2011: app.A).

The IASB thereby followed the FASB change in FAS 157, where “other than in a forced or liquidation sale” was replaced by “in an orderly transaction”, since it was considered redundant when assets and liabilities can be traded in efficient markets in an orderly fashion. Also, it picked up the change from “in a current transaction” to “at the measurement date”, recognizing that market prices are time-specific. Again, accounting here has changed to a social construction of consensus about subjective moments of assuming exposure (what is that?), for a period (how long?), with usual and customary marketing activities (such as?)

for such assets. An auditor cannot merely verify correspondence with external reality or with accepted criteria, but would necessarily have to participate in the social construction of realities.

It is assumed by the IASB that the most advantageous market is used, i.e. the market that “maximizes the amount that would be received to sell the asset [...] after considering transaction costs and transport costs” (IASB, 2011: app.A). Transaction costs are considered, but fair value shall not be adjusted for those costs (para.25). There is again a strong potential for subjectivity here in that the most advantageous market can be different from entity to entity. Is it the wholesale market or the retail market for example? The IASB recognizes this and states therefore that this most advantageous market “shall be considered from the perspective of the [reporting] entity” (para.19). Since this could necessitate an exhaustive search, the IASB states in para.17 that the most advantageous market is the market in which the entity would normally enter into transaction for the asset. This would be the *principal* market, i.e. the market with the greatest volume and level of activity, provided the entity can access this market (IASB, 2011: app.A). The company does therefore not have to construct this reality socially, but is allowed to construct it alone. An auditor though would have to verify this, necessitating a social construction, where management’s constructions would have to be exposed to the auditor’s construction in order to reach consensus.

Without an actual transaction, a hypothetical transaction at that date is assumed, which according to the IASB (2011: para.22) requires considering the characteristics of market participants who would enter into a transaction. The IASB again followed the FASB’s change in FAS 157, which had replaced “between willing parties” with “between market participants”, to further emphasize that fair value is market-based, i.e. established with reference to market prices, rather than entity specific (seller’s) anticipated prices. This is the next great moment of subjectivity. *Market participants* are buyers and sellers that are independent of each other, i.e. they are not related parties as defined in IAS 24, are knowledgeable, i.e. sufficiently informed, in fact to the same degree as the reporting entity, able to enter and willing to enter into a transaction (IASB, 2011: app.A). This assumes that a socially constructed consensus exists between market participants. The traditional ASOBAC audit would again not suffice here, in that a different audit paradigm is needed, based on communicative action and the construction of consensus.

The IASB tries to get around this though. The Board in paragraph 22 does state that the fair value of an asset shall be measured “using the assumptions that market participants would use in pricing the asset”, which again would require consensus among market participants, e.g. on an asset’s rate of return. But the Board goes on to specify that actual specific market participants need not be identified by the reporting entity. Rather, the reporting entity has to identify characteristics that distinguish market participants *generally*, considering factors specific to the asset, the most advantageous market, and market participants with whom the entity would enter into a transaction. This is the same problem which debilitated the traditional FASB and IASB conceptual frameworks: users are the main focus of financial reporting and their objectives are the main objectives of financial reporting, but asking the users what this is, is not required. Instead, management can assume what users need, or the standard setter has already decided it for them, in that all users are interested in information about future cash flows (FASB, 1980).

Lastly, the IASB states that fair value is an exit price, thus rejecting the use of entrance or replacement values. As with the FASB, even though the IASB has specified that fair values should be exit prices, it also involves calculations of value-in-use or entrance values. Benston (2008) claims this is due to the fact that the price another firm might pay for an asset depends on the value of the asset to that firm, its value in use,

and perhaps also the realization that when there is no potential purchaser, exit values would be zero or even negative if the firm would have to pay to dispose of an asset.

Fair value is according to the IASB either directly observable or estimated using a valuation technique, in which case the characteristics of market participants again have to be taken into consideration (IASB, 2011: para.18). Fair value considers a market participant's ability to generate economic benefit by using the asset, or by selling it to another participant, who will use it in its highest and best use (IASB, 2011: para.27), either stand-alone or in a groups of assets. This use considers physical possibility (f.ex. location or size), legal permission (f.ex. regulations), and financial feasibility (i.e. generating adequate income or cash flows to produce a required investment return). These characteristics are not viewed from either the side of the reporting entity or the side of the acquirer though, but from the perspective of market participants (IASB, 2011: para.28-29).

This independence of both auditee and auditor is consistent with audit evidence quality hierarchies (Power, 2010). But to achieve this, not only a "major informational undertaking" (Benston, 2008: 103) is required, but also a construction of social consensus among market participants. Another major problem is that value is subjective. Different people perceive value differently, so do different companies with different visions, different strategies, different operations, let al.one different industries. Miller (2008) even claims that variation in companies' rate of return is greater from *intraindustry* sources than it is from *interindustry* differences. The dominant characteristic of markets is thus heterogeneity, not homogeneity. Miller claims that "competitors' different views and different performance suggest major disparities among them over how, and even which, long-lived assets should be deployed". This points to different assumptions about the rates of return on those assets, and thus about the prices of (long-lived) assets. Thus, the pricing consensus implied by the standard-setters is refuted by research.

It also has major consequences for auditors, in that it requires them to determine highest and best use, physical possibility, legal permission, and financial feasibility, all from the side of "market participants", whoever they might be, and then determine whether management's construction of these factors is valid. The IASB states that an exhaustive search is not necessary, but does give an example of fair value's incremental value in paragraphs 31ff that would require an entity and its auditors to make subjective decisions as to whether the assets could be used differently. This is a fundamental change in auditing's methods.

As Power (2010) has argued with respect to Barth's (2007) claim that reliability no longer is to be identified with verifiability, but with faithful representation, this reframing of reliability, essentially collapsing it into relevance, has profound implication for the main auditing paradigm. In the traditional transactions-based view, auditing has been seen as checking audit trails linking accounting events to accounting reports, with different levels of audit evidence quality. Auditors are then the technical experts, whose professional judgment and opinion can be relied on as authoritative. But with the change to fair value, authoritative valuation has moved to markets and the economic valuation models underlying them. Unfortunately for auditors, they have no special expertise, judgement or opinion with respect to the inputs, assumptions, and parameters of these economic valuation models. Lacking this knowledge base and the consequential need for "outsourcing" their opinion (Power, 2010), seriously threatens the auditing profession's legitimacy; this in a time when auditing's value and role already is scrutinized from several sides (e.g. EC, 2010).

4.3 Fair Value Valuation Techniques and the Social Construction of Consensus

Even though fair value has become institutionalized to limit management's discretion in valuation, critics argue that fair value only exacerbates the problem (Ronen, 2008). As Benston (2008: 102) points out, the word "would" in the definition of fair value implies that in the absence of actual market transactions, fair values often will be based on hypothetical transactions. When fair value is not directly observable, valuation techniques should be used. These can be divided into market approaches, income approaches, and cost approaches. Market approaches use prices and other relevant information generated by market transactions involving identical or comparable assets. As the IASB states in IFRS 13, the selection of the appropriate market multiple from a range with different multiples for different comparables requires judgment by management, considering qualitative and quantitative factors (para.B6). Income approaches use techniques to convert expected future amounts to a single present discounted amount, based on current market expectations. This also requires judgment. Finally, cost approaches reflect the amount that currently would be required to replace the service capacity of an asset (current replacement cost) (IASB, 2011: app.B). This also requires judgment, since one has to estimate a replacement price for an asset of comparable utility, adjusted for physical, functional and economic obsolescence.

Other moments of subjectivity are present in that management has to choose valuation techniques "that are appropriate in the circumstances" and for which "sufficient data are available", maximizing the use of relevant observable inputs (market data) and minimizing the use of unobservable inputs (para.61). Also, when multiple valuation techniques are used, the respective results have to be "evaluated, as appropriate, considering the reasonableness of the range of values" (para.63). The "most representative" has to be chosen under the circumstances, whatever that may be.

IFRS 13 thus establishes a fair value hierarchy that prioritizes the inputs to valuation techniques into three levels. Level one-inputs are quoted prices in active markets for identical assets that the entity can access at the measurement date. Active markets have transactions with "sufficient frequency and volume to provide pricing information on an ongoing basis" (app.A). Paragraphs 78ff contain more subjective judgments that management has to make in order to achieve a fair value. Level two inputs are inputs that are observable for the asset, either directly, such as quoted prices for similar assets in active markets or identical or similar assets in inactive markets, or indirectly, such as inputs other than prices that are observable from the asset or derived principally from or corroborated by observable market data by correlation or other means. This again depends on several subjective factors, like the assets condition and location, the volume and level of activity on the market and so on (para.83). Level three inputs are inputs that are not based on observable market data (unobservable inputs), but on "the best information available in the circumstances" (IASB, 2011: para.89). An exhaustive search is according to the IASB not necessary, but reasonably available information may not be ignored. The Board also proposed a requirement for the reporting entity to disclose a measurement uncertainty analysis for level three fair value measurements, taking into account the effect of correlation between unobservable inputs in that analysis (IASB, 2010).

As clearly can be seen from the above, several subjective moments are present in determining the fair value of an asset. Fair value measurement requires the determination of the particular asset, the valuation premise that is appropriate, the most advantageous market for the asset, and the valuation technique appropriate for the measurement. Benston (2006; 2008) and Zack (2009) have shown that fair values other than those taken from quoted prices (level one) could be readily manipulated by opportunistic and

overoptimistic managers, for example by manipulating the estimates in present value calculations. The determination of fair values would also be costly to make, and very difficult and costly for auditors to verify and challenge, as exemplified in the Enron case. It would be very difficult for auditors to challenge the construction of management's numbers, in that management usually can claim they know the industry and the selling prices of assets better than the auditor. But auditors would still be left open to substantial liability claims, if their agreeing with the (social) constructions turn out to be incorrect.

Thus, we argue that the objective of accounting has changed from reporting a correspondence with reality, over reporting a correspondence with accepted criteria, to reporting a social construction of consensus among (market) participants. Ontologically and epistemologically, the underlying paradigm has moved away from (neo)positivistic truth and objectivity to (inter-)subjectivity. Economic reality is a subset of a wider social reality constructed by humans, and distinct from physical reality. This social reality is not completely objective, since we cannot represent reality apart from our subjective definitions of what constitutes reality (Ingram and Rayburn, 1989). By this we do not mean that accounting is not real. It means that objects of accounting do not exist independently of a socially-constructed, inter-subjective conceptual scheme, which is then objectified by virtue of collective intentionality. It is thus subjective by its very nature and in many cases, we can only faithfully represent our subjective construction of reality, not an empirical phenomenon. This is not an anti-realist viewpoint though, only anti-representationalist (McKernan, 2007). Irregardless of one's philosophical position, this subjective construction is dependent on human observation, consensus, and communication for its existence (cf. Habermas). McKernan (2007) also finds "a basis for objectivity in inter-subjectivity", i.e. in the relations between agents "reacting simultaneously to each other and stimuli from a shared world". This has major consequences for auditing.

For auditors, it is at the moment impossible to determine the representational faithfulness of accounting reports based on arbitrary GAAP. Thus in practice, their main task according to Lee (1993) appears to be one of recalculating the numbers "to ensure their calculational compliance with the rules of GAAP and the specific corporate circumstances". Auditors are then "assisting the report user to gain access to an unseen economic activity by means of attested but arbitrary accounting representations of it" (Lee, 1993: 158). But the truth of a particular account can only be understood in terms of the quality of inter-subjective agreement, in terms of "its auditability and verifiability" (McKernan, 2007: 158). If we want to improve objectivity, he argues we have to "deepen, broaden, and secure the quality of interactions within the community of minds". Accounting is best, when it has "a direct causal relation with objects and events upon which observers can triangulate" (McKernan, 2007: 159). This situation exists when dealing with "market values and transactions and with assets and liabilities that have a real presence in the environment that is corroborated by their existence in other belief systems" (McKernan, 2007). It is more difficult in situations where market values do not exist. Auditing in this fair value paradigm is then also best when it can verify the social construction of realities, which means deepening, broadening and securing the quality of consensus. Verification implies consensus (FASB, 1980: para.86). In order to verify this socially constructed linguistic information, "independently of the subjectivity of any one individual but inter-subjectively since many agents in the particular collectivity treat it as if it does exist" (Macintosh, 2006: 24), auditing has to develop new epistemic criteria. If these criteria are ignored by standard setters like the IAASB, it can only lead to "another exercise in professional legitimating" (Lee, 2006a: 3), and subsequent scandals and widening expectation gaps. The last section will briefly conclude and suggest which form these

criteria could take. This will of course require more future research, (political) changes in attitude, and so forth.

5. Conclusions and Implications

Accounting reports consist like any other speech act of different validity claims. We have shown that historically, when accounting's main focus has shifted from one of these validity claims to another, auditing has changed with it. Accounting's main paradigm for the first few millennia was about stewardship, i.e. the reporting of a steward to a principal for personal or fiscal accountability. The main audit paradigm was therefore one of checking truthfulness, i.e. the honesty and integrity of the steward, not the quality of the accounts. When in the 18-19th century, accounting's main paradigm changed to reporting the truth, i.e. congruence between reports and some form of external reality, auditing changed accordingly, in that verification of a "true and correct" view of this external reality became the main focus. When accounting in the second half of the 20th century again changed to reporting "in accordance with GAAP", i.e. a correspondence with established criteria, auditing also changed correspondingly, culminating in ASOBAC (AAA, 1973).

Now, for better or worse, accounting has again changed to the fair value paradigm. Many arguments have been given for or against the use of fair value, although most not well-supported by evidence (Laux and Leuz, 2009). Power (2010) argues that opponents of fair value had no fitting 'grand narrative' to compete with fair value, moving the debate to the necessarily messy level of implementation. Fair value proponents could build their paradigm on the legitimized discipline of financial economics, thus replacing the authority of law. Power (2010) still considers fair value accounting's perceived potential to minimise management's freedom to manipulate accounting numbers as one of the main motivations behind fair value accounting's recent momentum. However, the promulgation of fair value accounting has apparently not empowered auditors.

On the contrary, the fair value paradigm is "forcing traditional auditability values into a subsidiary position", where "auditing is more or less forced to hitch a ride on the numbers produced by the fair value measurement process or subcontract modelling expertise where necessary" (ibid.206). Power notes that the control of audit criteria now rests with accounting standard-setters like the IASB, with little influence for auditing standard setters like the IAASB (ibid: 206). At the same time, these standard-setters have become more autonomous and dominated by intellectuals heavily influenced by financial economics. We agree with this analysis, and would like to expand on the implications this has for auditing standard-setters, and eventually practitioners.

Accounting can be said to have internal validity criteria that specify whether accounting reports are valid or not. As we have discussed, accounting reports (a form of 'speech acts') can be criticized on at least three kinds of validity claims, i.e. truth in the objective world, rightness in the social, inter-subjective world, and truthfulness in the subjective world. With respect to external financial reporting, validity criteria thus include relevance, reliability, the faithful representation of some kind of external economic reality, and other criteria in accordance with the applicable financial reporting framework (GAAP) established by bodies like the IASB.

Auditing on the other hand has its own internal validity criteria. By implication, some of these are shared with accounting. Firstly, auditors express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (ISA 200: para.3). In so far as auditing thus expresses an opinion on whether the internal validity criteria of accounting, like relevance and faithful representation, have been applied correctly, they can be said to share methods with accounting. Secondly, by checking representational faithfulness, auditors also express an opinion on whether the financial statements are in correspondence with this external economic reality, a true and fair view. Thirdly, auditors check the veracity of the reporting party, i.e. the truthfulness of management.

But another important aspect concerning validity criteria is that auditors have their own internal validity criteria with respect to auditing methods and auditing techniques that are not shared with accounting. These are for example ethical requirements, professional judgment and scepticism, and all other requirements stated in the International Standards on Auditing, e.g. with regard to evidence, which enable an auditor to form that opinion. We argue that the social constructions necessitated by the change to the fair value paradigm have profound implications for this fourth kind of auditing validity criteria, the ISAs.

With respect to fair value accounting and the auditor's opinion on whether the financial statements are prepared in all material aspects with the applicable financial reporting framework (see also ISA 540: para.8), this framework, including accounting validity criteria like relevance and faithful representation, has changed. This of course requires a change in auditing, in that auditors have to incorporate the new accounting standards and criteria regarding fair value into their evaluating processes. Auditors thus have to check whether the methods, models and experts used by management in estimating fair value are "appropriately" and "consistently" applied (ISA 540). This is more of a change in content though, and not so much a change in process. "Traditional" auditing methods in checking document trails, calculations, and the like can be used here.

What we implicate here is that this change to fair value accounting also necessitates a change in auditing's internal methods and techniques. Since the foundation of accounting with the shift to fair value changes from philosophical suppositions about neo-positivistic correspondence-with-reality or correspondence-with-criteria to a social construction of consensus, an essential tension arises with auditing's methods and techniques, which are built on the neo-positivistic paradigm. Auditing's methods and techniques are characterized by deep intrinsic suppositions based on neo-positivist ideals of checking correspondence with facts, with an external (economic) reality, or with accepted criteria. If we accept the changes in accounting, adopting the new social construction of reality, the methods of checking the correspondence with facts and criteria, which now is essential to being a proper auditor, are no longer epistemically possible.

In order to determine a fair value measurement, management has compiled a set of relevant information at that measurement date, which should include the number of causal factors for determining fair value and a weighing of these factors. This affects the degree of uncertainty and thus the risk of material misstatement (ISA 540: para.2). Auditors then can proceed in their traditional way, by checking the method of this valuation, i.e. they can evaluate the audit trail consisting of documentary evidence about assumptions, uncertainty etc. for the set of relevant information, which management has compiled in determining fair value. This is also what ISA 540 requires. However, ISA 540 (para.13) also requires an auditor under certain circumstances to develop his or her own point estimate or a range to evaluate management's point estimate. Therefore, an auditor also has another role, which is to evaluate, whether

the relevant set of information is epistemically responsible, i.e. are all causal factors included and weighed correctly in the set of relevant information (see for example ISA 540: para.A82, which states that auditors could consider whether management “has incorporated the best information available in the circumstances”). In other words, auditors should be able to compile their own set of relevant information, which for management ideally would be a mirrored mapping of management’s set, or at least does not show material discrepancies.

What happens if there are material discrepancies is not made clear in ISA 540. Paragraph 13 states that auditors should “evaluate any significant differences from management’s point estimate”. In ISA 540: para. A92 this is expanded upon:

When the auditor makes a point estimate or a range and uses assumptions or a method different from those used by management, paragraph 13(d)(i) requires the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate. This understanding provides the auditor with information that may be relevant to the auditor’s development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management’s point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

What this paragraph states is firstly that it contributes to the auditor’s understanding of management’s estimate, his or her own estimate, and the difference between them. Great, but what is an auditor to do if his or her estimate is different, but, as stated, “equally valid”? If a factual error is made, there is no problem, since this can be corrected. But equally valid answers pose a real problem for auditors signing off on financial statements. Should they qualify the audit report? If we accept the changes in accounting to a fair value paradigm, we have argued that it is principally impossible for management and for auditors to determine with a high degree of epistemic certainty that the future will be in the way they estimate. ISA 540 on *Auditing Accounting Estimates, including Fair Value Accounting Estimates* recognizes that a difference between the informed guess at the measurement date and an actual outcome does not necessarily represent a misstatement, because of subsequent events or conditions. But it remains an informed guess, a social construct determined in part by the assumptions about inputs, uncertainty estimates and the like. Unfortunately, auditors are currently not only unequipped to make these informed guesses, they are also unequipped in determining what to do with equally valid estimates.

It will require more future research before auditing standard-setters can develop standards incorporating audit methods and techniques that can equip audit practitioners with tools to solve this problem. We would here like to point to one possible solution, using Habermas’ ideal speech situation. As ISA 540 para.A92 states, it might be “helpful in drawing conclusions to discuss with management the basis for the

assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate". Even though this would constitute what Power (2010) calls "a radical change programme for the expertise base of [auditing]", auditors in our opinion would have to participate in this discussion or discourse around the social construction of the fair value estimate, using discourse ethics.

As Arrington and Puxty (1991) have described for accounting, in order to rationally justify accounting's validity claims on truth, rightness and truthfulness, auditors have to change their internal methods to incorporate those of the ideal speech situation (Habermas, 1990):

1. Every (material) subject who so desires, is allowed to participate in the discourse.
2. Each subject is allowed to offer any proposal (raise a validity claim)
3. Each subject is allowed to question any proposal (criticize other validity claims).
4. No subject is coerced by forces either inside the discourse or outside the discourse in using the rights stated in 1., 2. and 3.

This would be a radical change programme indeed. Auditing would have to be re-thought from the all-knowing expert auditor, who like a pater familias knows best for his children, and decides ex-post in a status audit, whether a true and fair view was accomplished, to a process auditor, who has to verify whether the conditions of the ideal speech situation were obtained with a high degree of certainty, thereby automatically verifying a rationally justified valid outcome. Power already called for this change in audit paradigm in 1994, when he criticized the common audit style of quantified single measures, controlled ex-post by private external agencies using long distance methods, based on low trust, and stressing discipline, calling for a more qualitative audit, using multiple measures and local methods by internal agencies, based on high trust, autonomy, real time control, and public dialogue. Maybe a radical change is what auditing needs. Traditional auditing methods at least do not seem to have minimized scandals, lessened the expectations gap, and heightened trust and legitimacy in the auditing profession.

REFERENCES

AAA (1936), "A Tentative Statement of Accounting Principles Affecting Corporate Reports," *Accounting Review*, 187-191.

AAA (1966), *ASOBAT: A Statement of Basic Accounting Theory*. Sarasota, Fl: American Accounting Association.

AAA (1973), *ASOBAC: A Statement of Basic Auditing Concepts*, Sarasota, Fl: American Accounting Association.

AICPA (1962), "*Statement by the Accounting Principles Board*", American Institute of Certified Public Accountants: New York

Alexander, David (2007), "Recent history of fair value," in *The Routledge Companion to Fair Value and Financial Reporting*, Peter Walton, Ed. London: Routledge.

Alexander, David and Simon Archer (2003), "On economic reality, representational faithfulness and the 'true and fair override'," *Accounting & Business Research*, 33 (1), 3-17.

- Alexander, Sidney S. (1950), "Income Measurement in a Dynamic Economy," in *Five Monographs on Business Income*, AIA, Ed. New York: American Institute of Accountants.
- Arrington, C. Edward and Anthony G. Puxty (1991), "Accounting, Interests, and Rationality: A Communicative Relation," *Critical Perspectives on Accounting*, 2 (1), 31-58.
- ASB (1999), "Statement of Principles for Financial Reporting", Accounting Standards Board: London
- Barlev, Ben Zion and Joshua Rene Haddad (2007), "Harmonization, Comparability, and Fair Value Accounting," *Journal of Accounting, Auditing & Finance*, 22 (3), 493-509.
- Barth, Mary E., William H. Beaver, and Wayne R. Landsman (2001), "The relevance of the value relevance literature for financial accounting standard setting: another view," *Journal of Accounting and Economics*, 31 (1-3), 77-104.
- Barth, Mary E., William H. Beaver, and Wayne R. Landsman (1996), "Value-Relevance of Banks' Fair Value Disclosures under SFAS No. 107," *Accounting Review*, 71 (4), 513-537.
- Barth, Mary E. and Wayne R. Landsman (1995), "Fundamental Issues Relating to Using Fair Value Accounting for Financial Reporting," *Accounting Horizons*, 9 (4), 97-107.
- Benston, George J. (2006), "Fair-value accounting: A cautionary tale from Enron," *Journal of Accounting and Public Policy*, 25 (4), 465-484.
- Benston, George J. (2008), "The shortcomings of fair-value accounting described in SFAS 157," *Journal of Accounting and Public Policy*, 27 (2), 101-114.
- Benston, G.J., Bromwich, M. & Wagenhofer, A. (2006), "Principles- versus rules-based accounting standards: The FASB's standard setting strategy", *Abacus*, vol. 42, no. 2, pp. 165-187.
- Boer, Germain (1966), "Replacement Cost: A Historical Look," *Accounting Review*, 41 (1), 92-97.
- Boyd, Edward (1905/1968), "History of Auditing," in *A History of Accounting and Accountants*, Richard Brown, Ed. London: Frank Cass & Co.
- Brief, Richard P. (1966), "The Origin and Evolution of Nineteenth-Century Asset Accounting," *Business History Review*, 40 (1), 1-23.
- Briloff, A.J. (1964), "Needed: a revolution in the determination and application of accounting principles", *Accounting Review*, vol. 39, no. 1, pp. 12-15.
- Briloff, A.J. (1966), "Old myths and new realities in accountancy", *Accounting Review*, vol. 41, no. 3, pp. 484-495.
- Briloff, A.J. (1966), "The responsibilities of the CPA for fair corporate accountability", *Financial Analysts Journal*, vol. 22, no. 3, pp. 51-55.
- Broadbent, Jane and Richard Laughlin (1997), "Developing empirical research: an example informed by a Habermasian approach ", *Accounting, Auditing & Accountability Journal*, 10 (5), 622-648.
- Bromwich, Michael (2007), "Fair Values: Imaginary Prices and Mystical Markets," in *The Routledge Companion to Fair Value and Financial Reporting*, Peter Walton, Ed. London: Routledge.
- Brown, R. Gene (1962), "Changing Audit Objectives and Techniques," *Accounting Review*, 37 (4), 696-703.
- Brown, Richard Ed. (1905/1968), *A History of Accounting and Accountants*. London: Frank Cass & Co.
- Canning, John B. (1929/1978), "The Economics of Accountancy. A Critical Analysis of Accounting Theory.," in *The Development of Contemporary Accounting Thought*, Gary John Previts and Basil S. Yamey and Stephen A. Zeff, Eds. New York: Arno Press.

- Carmona, S. 2004, "Accounting history research and its diffusion in an international context", *Accounting History*, vol. 9, no. 3, pp. 7-23.
- Carson, A.B. (1949), "A "Source and Application of Funds" Philosophy of Financial Accounting," *The Accounting Review*, 24 (2), 159-170.
- Chandler, R. & Edwards, J.R. 1996, "Recurring issues in auditing: back to the future?", *Accounting, Auditing & Accountability Journal*, vol. 9, no. 2, pp. 4-29.
- Chambers, R. J. (1962), *Towards a general theory of accounting*, Melbourne: Australian Society of Accountants
- Chambers, R. J. (1966), *Accounting, Evaluation and Economic Behaviour*. Englewood Cliffs, NJ: Prentice Hall.
- Chambers, R. J. (1968), "Measures and Values," *Accounting Review*, 43 (2), 239-247.
- Chambers, R. J. and P. W. Wolnizer (1991), "A true and fair view of position and results: the historical background," *Accounting, Business & Financial History*, 1 (2), 197-213.
- Chandler, R.A. (1997), "Judicial views on auditing from the nineteenth century", *Accounting History*, vol. 2, no. 1, 61-80.
- Chatfield, M. (1974), *A History of Accounting Thought*. Hinsdale, Illinois: The Dryden Press.
- Chua, W.F. (1986), "Radical Developments in Accounting Thought", *The Accounting Review*, vol. LXI, no. 4, pp. 601-632.
- Costouros, George J. (1978), "Auditing in the Athenian State of the Golden Age (500-300 BC)," *Accounting Historians Journal*, 5 (1), 41-50.
- Dicksee, L.R. (1933), *Auditing*, Gee.
- EC (2010), "COM (2010) 561 Green Paper. Audit Policy: Lessons from the Crisis", Brussel: European Commission.
- Edwards, Edgar O. and Phillip W. Bell (1961), *The theory and measurement of business income*. Berkeley: University of California Press.
- Elliott, R.K. & Jacobson, P.D. (1987), "Audit technology: A heritage and a promise", *Journal of Accountancy*, vol. 163, pp. 198-217.
- FASB (1980), "Statement of Financial Accounting Concepts No. 2. Qualitative Characteristics of Accounting Information.", Financial Accounting Standards Board: Norwalk, CT
- FASC (2007), "The FASB's Conceptual Framework for Financial Reporting: A Critical Analysis," *Accounting Horizons*, 21 (2), 229-238.
- FASC (2005), "Response to the FASB's Exposure Draft on Fair Value Measurements," *Accounting Horizons*, 19 (3), 187-196.
- FASC (2000), "Response to the FASB Preliminary Views: Reporting Financial Instruments and Certain Related Assets and Liabilities at Fair Value," *Accounting Horizons*, 14 (4), 501-508.
- Flint, David (1988), *Philosophy and Principles of Auditing: An Introduction*. Basingstoke: Macmillan Press.
- Flint, David (1971), "The role of the auditor in modern society: an exploratory essay," *Accounting and Business Research*, 1 (1), 287-293.
- Fogarty, T.J., Hussein, M.E.A. & Ketz, J.E. (1994), "Political Aspects of Financial Accounting Standard Setting in the USA", *Accounting, Auditing & Accountability Journal*, vol. 7, no. 4, pp. 24-46.

- Georgiou, Omiros and Lisa Jack (2011), "In pursuit of legitimacy: A history behind fair value accounting," *British Accounting Review*, In Press (doi:10.1016/j.bar.2011.08.001).
- Gerboth, D.L. (1973), "Research, Intuition, and Politics in Accounting Inquiry", *The Accounting Review*, , no. 3, pp. 475-482.
- Gerboth, D.L. (1972), "Muddling through with the APB", *Journal of Accountancy*, , no. May, pp. 42-49.
- Habermas, Jürgen (1984), *The Theory of Communicative Action. Volume 1: Reason and the Rationalization of Society* (Thomas McCarthy, Trans.). Boston: Beacon Press.
- Habermas, Jürgen (1990), "Discourse Ethics: Notes on a Program of Philosophical Justification," in *Moral consciousness and communicative action* Cambridge: Polity Press.
- Hines, Ruth D. (1991), "The FASB's Conceptual Framework, Financial Accounting and the Maintenance of the Social World," *Accounting, Organisations and Society*, 16 (4), 313-331.
- Hines, Ruth D. (1988), "Financial accounting: In communicating reality, we construct reality," *Accounting, Organizations and Society*, 13 (3), 251-261.
- Horngren, C.T. (1973), "The marketing of accounting standards", *Journal of Accountancy*, vol. 136, no. 4, pp. 61-66.
- House of Commons Treasury Committee (2009), *"Banking Crisis: reforming corporate governance and pay in the city"*, House of Commons: London
- IAASB (2008), "Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment", IAASB Staff Audit Practice Alert.
- IASB (2009), *"ED/2009/5 Fair Value Measurement"*, International Standards Accounting Board: London
- IASB (2010), *"ED/2010/7 Measurement Uncertainty Analysis Disclosure for Fair Value Measurements."*, International Accounting Standards Board: London
- IASB (2011), *"IFRS 13 Fair Value Measurement"*, International Accounting Standards Board: London
- IASC (1989), *"Framework for the Preparation and Presentation of Financial Statements"*, International Accounting Standards Committee: London
- IASC/CICA Steering Committee on Financial Instruments, "Accounting for Financial Assets and Financial Liabilities", *Accounting Horizons*, 12 (1), 90-97.
- ICAS (2010), *"Should Statutory Audit be dropped and Assurance needs left to the Market?"*, The Institute of Chartered Accountants of Scotland: London
- Ingram, Robert W. and Frank R. Rayburn (1989), "Representational faithfulness and economic consequences: Their roles in accounting policy," *Journal of Accounting and Public Policy*, 8 (1), 57-68.
- Jeppesen, K.K. (2010), "Strategies for dealing with standard-setting resistance", *Accounting, Auditing & Accountability Journal*, vol. 23, no. 2, pp. 175-200.
- Jones, Michael John (2008), "Internal control, accountability and corporate governance. Medieval and modern Britain compared," *Accounting, Auditing & Accountability Journal*, 21 (7), 1052-1075.
- Kenny, S.Y. & Larson, R.K. (1993), "Lobbying behaviour and the development of international accounting standards", *European Accounting Review*, vol. 3, pp. 531-554.
- Kitchen, J. (1982), "Auditing: past development and current practice," in *Auditing Research: Issues and Opportunities*, Anthony Hopwood and M. Bromwich and J. Shaw, Eds. London: Pitman Books.

- Laughlin, Richard (1987), "Accounting Systems in Organisational Contexts: A Case for Critical Theory," *Accounting, Organizations and Society*, 12 (5), 479-502.
- Laughlin, Richard C. (1995), "Empirical research in accounting: alternative approaches and a case for "middle-range" thinking," *Accounting, Auditing & Accountability Journal*, 8 (1), 63-87.
- Landsman, Wayne R. (2007), "Is fair value accounting information relevant and reliable? Evidence from capital market research," *Accounting & Business Research*, 38 (1), 19-30.
- Laux, Christian and Christian Leuz (2009), "The crisis of fair-value accounting: Making sense of the recent debate," *Accounting, Organizations and Society*, 34 (6-7), 826-834.
- Lee, T. A. (1993), *Corporate Audit Theory* (1st ed.). London: Chapman & Hall.
- Lee, T.A. (1994), "Financial Reporting Quality Labels. The Social Construction of the Audit Profession and the Expectations Gap," *Accounting, Auditing and Accountability Journal*, 7 (2), 30-49.
- Lee, T.A. (2006a), "The FASB and Accounting for Economic Reality," *Accounting & the Public Interest*, 6:1-21.
- Lee, T. A. (2006b), "Cunning Plans, Spinners, and Ideologues: Blackadder and Baldrick Try Accounting for Economic Reality," *Accounting & the Public Interest*, 6, 45-50.
- Lee, T. A. (2008), "Book Review: The Routledge Companion to Fair Value and Financial Reporting," *Accounting & Business Research*, 38 (1), 93-96.
- Liempd, Dennis van and Frederik Zachariassen (2011), "Historical Macro Trends in Auditing's Validity Claims", Paper presented at 34th Annual Congress European Accounting Association, Rome, Italy.
- Linsmeier, Thomas J., James R. Boatsman, Robert H. Herz, Ross G. Jennings, Gregory J. Jonas, Mark H. Lang, Kathy R. Petroni, D. Shores, and James M. Wahlen (1998), "Response to a Discussion Paper Issued by the International Auditing and Assurance Standards Board (2008), *Challenges in auditing fair value accounting estimates in the current market environment*, IFAC Staff Audit Practice Alert.
- Littleton, A.C. (1966), *Accounting Evolution to 1900*. New York: Garland Publishing Inc.
- Macintosh, Norman B. (2006), "Accounting--Truth, Lies, or "Bullshit"? A Philosophical Investigation," *Accounting & the Public Interest*, 6, 22-36.
- Macintosh, N.B. (2009), "Accounting and the Truth of Earnings Reports: Philosophical Considerations", *European Accounting Review*, vol. 18, no. 1, pp. 141-175.
- MacNeal, Kenneth (1939), *Truth in Accounting*. Houston, TX: Scholars Book Co.
- MARC (2010), *"The Value of Audit"*, Maastricht: Maastricht Accounting, Auditing and Information Management Research Center.
- Masocha, V. & Weetman, P. (2007), "Rhetoric in standard setting: the case of the going-concern audit", *Accounting, Auditing & Accountability Journal*, vol. 20, no. 1, pp. 74-100.
- Mautz, R.K. and Hussein A. Sharaf (1961), *The Philosophy of Auditing*. Sarasota: American Accounting Association.
- McCarthy, Thomas (1976/1997), "Translator's Introduction," in *Legitimation Crisis*, Jürgen Habermas, Ed. Cambridge: Polity Press.
- McKernan, J.F. (2007), "Objectivity in accounting," *Accounting, Organizations and Society*, 32: 1-2, 155-180.
- Miller, P., Hopper, T. & Laughlin, R. 1991, "The New Accounting History: An Introduction", *Accounting, Organizations and Society*, vol. 16, no. 5/6, pp. 395-403.

- Mills, Geoffrey T. (1994), "Early Accounting in Northern Italy: The role of commercial development and the printing press in the expansion of double-entry from Genoa, Florence and Venice," *Accounting Historians Journal*, 21 (1), 81-.
- Moonitz, Maurice (1961/1982), "Accounting Research Study No.1 The Basic Postulates of Accounting," in *The Accounting Postulates and Principles Controversy of the 1960s*, Stephen A. Zeff, Ed. New York: American Institute of Certified Public Accountants/Garland Publishing Inc.
- Moonitz, M. (1974), *Obtaining agreement on standards in the accounting profession*, American Accounting Association Sarasota, FL.
- Mouck, Tom (2004), "Institutional reality, financial reporting and the rules of the game," *Accounting, Organizations and Society*, 29 (5-6), 525-541.
- Moxter, Adolf (1982), *Betriebswirtschaftliche Gewinnermittlung*. Tübingen: J.C.B. Mohr (Paul Siebeck).
- Napier, C.J. 2001, "Accounting history and accounting progress", *Accounting History*, vol. 6, no. 2, pp. 7-31.
- Pacioli, Luca (1494/1924), *Double Entry Book-keeping* (Pietro Crivelli, Trans.): the Institute of Book-keepers.
- Paton, William A. and A.C. Littleton (1940), *Monograph No.3: An Introduction to Corporate Accounting Standards*, American Accounting Association: Sarasota, FL
- Pong, Christopher K. M. and Geoffrey Whittington (1996), "The Withdrawal of Current Cost Accounting in the United Kingdom: A Study of the Accounting Standards Committee," *Abacus*, 32 (1), 30.
- Power, M.K. (1992), "From common sense to expertise: Reflections on the prehistory of audit sampling", *Accounting, Organizations and Society*, vol. 17, no. 1, pp. 37-62.
- Power, M. (1993), "The politics of financial auditing," *Political Quarterly*, 64 (3), 272.
- Power, M. (1994), *The Audit Explosion*. London: Demos.
- Power, M. (1996), "Making Things Auditable," *Accounting, Organizations and Society*, 21 (2/3), 289-315.
- Power, M. (1997), *The Audit Society*. Oxford: Oxford University Press.
- Power, M. (2010), "Fair value accounting, financial economics and the transformation of reliability," *Accounting and Business Research*, 40 (3), 197-210.
- Richard, Jacques (2004), "The Secret Past of Fair Value: Lessons from History Applied to the French Case," *Accounting in Europe*, 1, 95-107.
- Ronen, Joshua (2008), "To Fair Value or Not to Fair Value: A Broader Perspective," *Abacus*, 44 (2), 181-208.
- Rorem, C.R.(1929), "Replacement Cost in Accounting Valuation," *The Accounting Review*, 4 (3), 167-174.
- Ruland, R.G. (1984), "Duty, obligation, and responsibility in accounting policy making", *Journal of Accounting and Public Policy*, vol. 3, no. 3, pp. 223-237.
- Schipper, Katherine (2003), "Principles-Based Accounting Standards," *Accounting Horizons*, 17:1, 61-72.
- Searle, J.R. (1995), *The Construction of Social Reality*. New York: Free Press.
- Shapiro, Brian P. (1997), "Objectivity, relativism, and truth in external financial reporting: What's really at stake in the disputes?," *Accounting, Organizations and Society*, 22 (2), 165-185.
- Simon, Herman Veit (1899), *Die Bilanzen der Aktiengesellschaften und der Kommanditgesellschaften auf Aktien* (3rd ed.). Berlin: J. Guttentag.
- Sismondo, Sergio (1993), "Some Social Constructions," *Social Studies of Science*, 23 (3), 515-553.
- Solomons, D. (1978), "The Politicization of Accounting", *Journal of Accountancy*, , no. November, pp. 65-72.

- Solomons, D. (1983), "The Political Implications of Accounting and Accounting Standard Setting", *Accounting and Business Research*, , no. Spring, pp. 107-118.
- Solomons, D. (1991), "Accounting and social change: a neutralist view", *Accounting, Organizations and Society*, vol. 16, no. 3, pp. 287-295.
- Solomons, D. (1995), "Criteria for choosing an accounting model", *Accounting Horizons*, vol. 9, no. 1, pp. 42-51.
- Sprouse, Robert and Maurice Moonitz (1962/1982), "Accounting Research Study No. 3: A tentative set of broad accounting principles for business enterprises," in *The Accounting Postulates and Principles Controversy of the 1960s*, Stephen A. Zeff, Ed. New York: American Institute of Certified Public Accountants/Garland Publishing Inc.
- Sterling, R. (1972), "Decision Oriented Financial Accounting," *Accounting and Business Research*, 2, 198-208.
- Sterling, R. (1970), "On Theory Construction and Verification," *The Accounting Review*, 45:3, 444-457.
- Sterling, Robert R. (1967), "A Statement of Basic Accounting Theory: A Review Article," *Journal of Accounting Research*, 5 (1), 95-112.
- Stone, W.E. (1969), "Antecedents of the Accounting Profession," *The Accounting Review*, 44:2, 284-291.
- Storey, R.K. (1959), "Revenue realization, going concern and measurement of income", *Accounting Review*, pp. 232-238.
- Sutton, T.G.(1984), "Lobbying of accounting standard-setting bodies in the UK and the USA: a Downsian analysis", *Accounting, Organizations and Society*, vol. 9, no. 1, pp. 81-95.
- Toba, Y. (1975), "A general theory of evidence as the conceptual foundation in auditing theory", *Accounting Review*, vol. 50, no. 1, pp. 7-24.
- Tweedie, D.P. and G. Whittington (1997), "The end of the current cost revolution," in *The development of accounting in an international context*, T. Cooke and C.W. Nobes, Eds. London: Routledge.
- Walton, Peter Ed. (2007), *The Routledge Companion to Fair Value and Financial Reporting*, London: Routledge.
- Watts, R.L. & Zimmerman, J.L. (1978), "Towards a Positive Theory of the Determination of Accounting Standards", *The Accounting Review*, , no. January, pp. 112-134.
- Wells, M.C. (1976), "A revolution in accounting thought?", *Accounting Review*, vol. 51, no. 3, pp. 471-482.
- Wilson, Allister and Ernst & Young (2001), "Fair Value and Measurement: Where the Conflicts Lie," *Balance Sheet*, 9:4, 26-33.
- Young, J.J. & Mouck, T. (1996), "Objectivity and the role of history in the development and review of accounting standards", *Accounting, Auditing & Accountability Journal*, vol. 9, no. 3, pp. 127-147.
- Zack, Gerard M. (2009), *Fair Value Accounting Fraud. New Global Risks and Detection Techniques*, Hoboken, NJ: John Wiley & Sons.
- Zeff, S.A. (1978), "The Rise of "Economic Consequences"", *Journal of Accountancy*, December, pp. 56-63.
- Zeff, S.A. (1982), "Truth in Accounting: The Ordeal of Kenneth MacNeal," *Accounting Review*, 57: 3, 528.
- Zeff, S.A. (2003), "How the U.S. Accounting Profession Got Where It Is Today: Part I", *Accounting Horizons*, vol. 17, no. 3, pp. 189-205.
- Zijl, Tony van and Geoffrey Whittington (2006), "Deprival Value and Fair Value: a reinterpretation and a reconciliation," *Accounting & Business Research*, 36 (2), 121-130.

¹ Habermas recognizes at least five, of which two (the fact that the speech act is understandable, and the fact that the speech act is effective) will be left out in this paper. Understandability between people is assumed here, even though it is recognized this is not always the case. For example, to understand this paper, one should be able to read the Latin script, the English language, and possess some linguistic and grammatical concepts and frameworks to be able to treat words and sentences and so on. The validity of efficacy is also left out. Effectiveness, economy, and efficiency are central to performance audits, but are not treated here, because of the paper's focus on traditional, financial auditing.

² His forward looking view could be seen both in his definition of assets, which focused on future services, and in his measurement of assets. He favoured the direct valuation of assets, i.e. the discounted present value of realized income, but only for such assets as cash, receivables and finished goods inventory. For other kinds he recommended indirect valuation: "the present worth of future outlays necessary to obtain like services in like amounts by the best available alternative means, less the present worth of future outlays necessary to obtain the agent's future service in the most economical manner" (Canning, 1929/1978: 188). Whittington states that the advocacy of the opportunity difference principle, i.e. valuing the asset in terms of the minimum cost of replacing its services, on the assumption that the services are essential to business operations and that it is economically worthwhile to continue operating, is Canning's main contribution to valuation.

³ MacNeal treated only marketable securities and raw materials as assets that have acceptable markets to use market prices. Since he was not interested in "future improbabilities, probabilities, or even certainties" (MacNeal, 1939: 146), he used replacement cost as a surrogate for nonmarketable and reproducible assets, and original cost less amortization or depletion for non-reproducible, non-marketable assets. His rhetoric against accountants and the concepts of historic cost and conservatism earned him little gratitude from practitioners or standard setters, but until MacNeal "no one had presented an integrated proposal for the preparation of financial statements on a market-price basis" (Zeff, 1982).

⁴ The average change in the US Consumer Price Index for 1946, 1947 and 1948 was 8.3%, 14.4% and 8.1% (<http://www.bls.gov/cpi/tables.htm>).

⁵ Moonitz (1961/1982; Sprouse and Moonitz, 1962/1982), for example, proposes discounted present value for receivables to be settled in cash, net realizable value for readily salable inventories, and replacement cost for other inventories and tangible fixed assets, adjusted for changes in price level. Both ARS No. 1 and ARS No. 3 advocated market price, as opposed to historical cost, as the primary basis of financial measurement. However, the APB considered the proposals of Sprouse and Moontitz to be "too radically different from present GAAP for acceptance at this time" (AICPA, 1962). A publication by accounting firm Arthur Andersen (1972) also focused on forward looking information and endorsed the use of current value accounting, but not by "valuing future resources", which they considered to be the responsibility of the investor.

⁶ The average change in the US Consumer Price Index for 1979, 1980 and 1981 was 11.3%, 13.5% and 10.3% (<http://www.bls.gov/cpi/tables.htm>)

⁷ The IFRS immediately makes exceptions in paragraph 6 and 7, and later on e.g. in para.48ff.