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Fair value accounting, financial economics and the transformation of reliability

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Abstract

This paper addresses the question of how and why the use of fair values in accounting acquired significance prior to 2007 despite widespread opposition. An answer is suggested in terms of four mutually supporting conditions of possibility which gave the proponents of fair value institutional support and strength which their opponents lacked. First, fair value enthusiasts could draw on the background cultural authority of financial economics. Second, the problem of accounting for derivatives provided a platform and catalyst for demands to expand the use of fair values to all financial instruments. Third, the transformation of the balance sheet by conceptual framework projects from a legal to an economic institution created a demand for asset and liability numbers to be economically meaningful, a demand which fair value could claim to satisfy. Fourth, fair value became important to the development of a professional, regulatory identity for standard-setters. These four conditions, though not sufficient in themselves, added up to a weakening of a transactions-based, realization-focused

conception of accounting reliability in favour of one aligned with markets and valuation models. An interesting consequence is that auditing standard-setters found themselves forced into a reactive role.

Keywords::

fair value accounting

measurement

reliability

financial economics

accounting policy

financial instruments

Notes

Michael Power is Professor of Accounting at the London School of Economics and Political Science. This paper is based on the 2009 P.D. Leake lecture delivered at Chartered Accountants' Hall, London on 15 October 2009. The lecture was entitled 'Fair value: the influence of financial economics on accounting'. The author is grateful for the financial support of the charitable trusts of the Institute of Chartered Accountants in England and Wales and for the invaluable comments of: Michael Bromwich, Robert Hodgkinson, Richard Laughlin, Andrew Lennard, Richard Macve, Christopher Napier, Brian Singleton-Green and Geoffrey Whittington.

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