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Changes in the measurement of fair value: Implications for accounting earnings

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ABSTRACT

With the FASB's issue of staff position papers in 2009 and the relaxation of how fair value standards are applied, there has been a change in the practice of how fair value is measured. Since the FASB staff position papers in 2009, fair value measurement by financial institutions has increasingly relied on managerial assumptions. This study examines the impact of this change on the quality of earnings. Consistent with attribute substitution theory that emphasises reliability over relevance, we find that an apparent increase in managerial discretion in fair value measurement is associated with a higher probability of earnings management and lower earnings informativeness. The results indicate that allowing more managerial discretion in fair value measurement adversely affected the quality of financial reporting. Our study highlights the issue of reliable measurement in the debate among academics and practitioners of increasing the use of fair value accounting.

1. Introduction

Drawing upon evidence from the case of Enron, Gwilliam and Jackson (2008) argue that the unreliability of mark to market valuations originates from managers' desire to manipulate earnings. More recently there has been a change in the practice of how fair value is measured after the Financial Accounting Standard Board (FASB)'s relaxation of the application of standards on fair value measurement (FASB, 2009a, 2009b). Fair value measurement increasingly relies on managerial assumptions, even including cases where a market price exists. Such a change has been subject to much debate among regulators, bank executives and investors (Bushman & Landsman, 2010). Supporters of the change argue that giving managers more discretion in fair value measurement will convey more relevant information. To the contrary, critics argue that greater flexibility in fair value measurement will be opportunistically exploited by managers and will adversely affect the reliability of fair value measurement.

While prior research documents the existence of potential manipulation of fair value estimates (Dechow, Myers, & Shakespeare, 2010; Fiecher & Meyer, 2010; Huizinga & Laeven, 2009; Vyas, 2010), there is relatively little empirical evidence specifically examining whether additional managerial discretion allowed by accounting standards on fair value measurement will, on average, reveal more about a firm's economic fundamentals or degrade the quality of earnings.[1]

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[1] See the debate between Dechow, Myers, et al. (2010) and Barth and Taylor (2010) on whether fair value estimates of securitisation gains are manipulated by managers. Barth and Taylor (2010) show that the evidence on this issue is inconclusive and further investigation is needed.

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This study extends the emerging literature on managerial discretion in fair value estimates to explore the question: "What are the effects of additional discretion in fair value measurement allowed by changes in accounting standards on banks' earnings?" Specifically, this study uses the relaxation by the FASB of the application of fair value standards for banks (FASB, 2009a, 2009b) to examine the relation between the change of fair value measurement in practice and the quality of banks' earnings.

In a move changing the standards on fair value measurement to enhance the relevance of financial reporting, the FASB issued three FASB Staff Position papers (FSPs) in April 2009 that effectively granted managers more flexibility to measure fair value assets at level 2 and 3 even where markets for the securities existed.[2] Bushman and Landsman (2010, page 271) state that: "both the FASB and IASB bent to political pressure and generally allowed banks more flexibility in applying their fair value accounting." This event provides an opportunity to examine the effects of increased managerial discretion in fair value measurement on banks' earnings quality.

In examining the quality of earnings, we focus on two attributes: reliability and relevance. These are two qualities of financial information used by both the Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB) in standard setting. To examine the reliability and relevance of earnings, consistent with the literature (e.g., Dechow, Ge, & Schrand, 2010), we examine the probability of earnings management and the informativeness of earnings as reflected in investors' response to earnings announcements. Using a sample of U.S. bank holding companies with fair value hierarchy disclosures, we find that an increase in measurement discretion in fair value increases the probability of meeting or beating analysts' forecasts and the effect occurs during the period after the relaxation of fair value rules. We also find that an increase in discretionary fair value assets negatively impacts the earnings response coefficient (*ERC*) and that the effect primarily comes from the period after the relaxation of fair value standards.

This study reveals that higher managerial discretion afforded from accounting standards is opportunistically exploited by managers in practice and will not enhance the relevance of financial reporting. Our results are consistent with the attribute substitution theory arguing relevance is a less accessible attribute than reliability in fair value (Kahneman & Frederick, 2002; Kadous, Koonce, & Thayer, 2012). When users of financial reports judge the source of information as unreliable, they will not treat the information as useful or relevant. In other words, fair value becomes less informative of value when it is not reliably measured (Hernández Hernández, 2004; Penman, 2007). By providing empirical evidence on the effects of a recent change in practice of fair value measurement, we caution the promotion of relevance in the sacrifice of reliability in financial reporting.

This study is organised as follows. Section 2 provides background on the institutional setting. Section 3 reviews prior research related to managerial discretion in fair value measurement and the quality of capital, and develops hypotheses. Sections 4 and 5 describe the model and sample. Section 6 presents the empirical results. Section 7 discusses sensitivity analyses. Section 8 concludes the paper.

2. Background

The use of fair value estimates can provide timely information about the changes in economic conditions and can serve as an early warning of adverse market conditions.[3] Fair values are determined and classified using three different approaches. Level 1 uses *unadjusted* quoted market price, however, level 2 and 3 fair value estimates use inputs and assumptions determined by managers. This hierarchy can provide timely information on how economic conditions may impact value, but also allows significant management discretion in measurement and classification.[4]

FAS 157 (FASB, 2006) originally did not allow fair value to deviate from market price when a quoted market price exists. To avoid recognising large impairment losses under FAS 157, banks lobbied law makers to ease the fair value rules and to give managers more flexibility in valuing assets using internal models (Pulliam & McGinty, 2009). Under political pressure from the Congress (Bushman & Landsman, 2010), the FASB issued three Staff Positions (FSPs) in April 2009 that gave managers more discretion in determining whether to use market price or an internal model to recognise the fair value of assets and liabilities. For example, FASB Staff Position No. FAS 157-4 (FASB, 2009a) gives managers more power to determine when the market is inactive and whether a transaction is not orderly. If the market price is judged not to be the result of orderly sales, managers can make adjustments to the market price using other valuation techniques, including internally developed models.

When managers believe that the market is illiquid and the market price does not reflect fundamental values of the assets, managers enjoy the flexibility not to use the quoted market price, i.e., level 1, as fair value. Instead managers can choose to use level 2 and 3 inputs to estimate fair value. Level 2 inputs are derived from prices of similar assets with additional

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[2] A *Wall Street Journal* article estimates that the change in fair value accounting boosted banks' earnings by 7% on average in Q2 2009 (Pulliam & McGinty, 2009).

[3] For example, the CEO of Goldman Sachs, Lloyd Blankfein, wrote in the *Financial Times*: "At Goldman Sachs, we calculate the fair value of our positions every day, because we would not know how to assess or manage risk if market prices were not reflected on our books. This approach provides an essential early warning system that is critical for risk managers and regulators" ('To avoid crises, we need more transparency', FT.com, October 2009).

[4] A representative example of an acknowledgement by management of the flexibility in measurement afforded by the choice of assumptions is: "The methods to estimate fair value may produce a fair value calculation that may not be indicative of net realisable value or reflective of future fair values." JP Morgan Chase 2010 10-K, page 157.