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The effect of Statement of Financial Accounting Standards No. 157 Fair Value Measurements on analysts' information environment ☆

Orie E. Barron [a], Sung Gon Chung [b], Kevin Ow Yong [c,*]

[a] *Pennsylvania State University, United States*
[b] *Wayne State University, United States*
[c] *Singapore Management University, Singapore*

A B S T R A C T

This study examines the effect of the adoption of Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (hereafter FAS 157) on analysts' information environment. A major controversy surrounding FAS 157 disclosures is whether Level 3 measurements provide useful information to financial statement readers. We provide evidence suggesting that FAS 157 disclosures regarding Level 3 measurements are able to reduce uncertainty in analysts' information environment. Our results reveal that the provision of such fair value disclosures is associated with reduced uncertainty regarding future earnings and lower forecast errors. We also find that unrealized gains and losses from fair value changes in Level 3 measurements are positively associated with firms' future performance. Overall, our findings suggest that disclosures related to FAS 157 fair value measurements improve analysts' information environment. Our findings thus contribute to the debate regarding the extent of fair value accounting in financial reporting.

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* Corresponding author.
E-mail addresses: oeb1@psu.edu (O.E. Barron), sgchung@wayne.edu (S.G. Chung), kevinowyong@smu.edu.sg (K.O. Yong).

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1. Introduction

The Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 157 *Fair Value Measurements* (hereafter FAS 157) in September 2006. The purpose was to enable financial statement readers to better interpret and understand reported fair value estimates across various categories of assets and liabilities. FAS 157 considerably increases the disclosure requirements related to the fair value estimation process, including disclosures about the methodologies and inputs used to determine fair values.[1] Thus, the adoption of FAS 157 provides a better means for interpreting fair value measurements as well as assessing the underlying reliability of the fair value estimates. Nevertheless, there are concerns regarding how much the improved disclosure requirements in FAS 157 are able to help financial statement readers better understand the fair value measurement process (AAA FASC, 2005; Ryan, 2008; SEC, 2008).

In this paper, we examine whether disclosures about Level 3 measurements as a result of FAS 157 adoption reduce analysts' uncertainty about future earnings for firms that hold significant amounts of Level 3 assets and liabilities (hereafter Level 3 assets for brevity).[2] A major controversy surrounding FAS 157 disclosures is whether mark-to-model measurements (i.e., Level 3 measurements) are able to provide useful information to market participants (e.g., Hodder et al., 2014). This is because Level 3 measurements require considerable managerial discretion in the appropriate selection and application of valuation techniques, forecast assumptions, and valuation inputs. The discretion afforded to managers in the fair value estimation of these measurements may lead to opportunistic managerial behavior that biases these estimates. Even in the absence of managerial bias, proper estimation of these fair values is more challenging due to general uncertainty in the selection of appropriate valuation parameters such as the relevant discount rate or the prediction of future cash flows.

In view of greater estimation uncertainty pertaining to these fair value measurements, standard setters require firms to prioritize Level 1 and Level 2 valuation inputs over Level 3 valuation inputs in the fair value measurement process. Standard setters also require firms to disclose more information pertaining to the fair value estimation process of Level 3 assets. These more comprehensive disclosures are intended to help a financial statement reader better understand the impact of Level 3 measurements on a firm's earnings and to reduce the opacity surrounding the fair value measurement process of these assets and liabilities.[3] Greater insights about the fair values of a firm's assets and liabilities should, in turn, help reduce analyst uncertainty about a firm's future performance (Barth, 2006, p. 283).

Prior research provides evidence suggesting that fair values based on unobservable inputs have higher information risk relative to those based on observable inputs (Riedl and Serafeim, 2011). There is also empirical evidence suggesting that investors have reliability concerns for Level 3 estimates (e.g., Song et al., 2010). While these studies investigate the cross-sectional differences in the information risk and reliability of Level 3 measurements relative to Level 1 and Level 2 measurements, our study examines the time-series differences in the firms' information environment before and after the adoption of FAS 157. Level 3 assets and liabilities existed before the adoption of FAS 157, but information regarding Level 3 estimates only became publicly available as a result of FAS 157 disclosure requirements. Hence, we examine whether more comprehensive disclosures about Level 3 measurements as a result of FAS 157 adoption is beneficial to analysts.

[1] A major disclosure requirement from FAS 157 is the disclosure of the fair value hierarchy information as a footnote disclosure. The disclosure of the fair value hierarchy provides information about how much of a firm's assets and liabilities are valued based on: (1) market prices directly (Level 1 inputs), (2) other observable market-based inputs (Level 2 inputs), or (3) firm-supplied unobservable inputs (Level 3 inputs). These fair value measurements were not previously disclosed to market participants prior to FAS 157 adoption.

[2] This category generally includes the following assets and liabilities: certain private equity investments; retained residual interests in securitizations; residential mortgage servicing rights (MSRs); asset-backed securities (ABS); highly structured, complex or long-dated derivative contracts; and certain collateralized debt obligations (CDOs) where independent pricing information is unavailable for a significant portion of the underlying assets.

[3] The Securities and Exchange Commission report on mark-to-market accounting (SEC, 2008, p. 90) states, "changes in the fair value of Level 3 instruments had a significant impact on equity. Using absolute dollars, the impact of Level 3 instruments was 10% and 7% of equity (on a comparable nine-month basis) for the first quarter and first three quarters of 2008, respectively."

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