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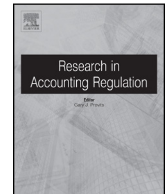

Regular Paper

The curious case of Level 3 instruments

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ABSTRACT

Standard setters and regulators face an ever-present concern over the discretionary influence firms have in financial reporting. For information to have enhanced relevance, some level of discretion in financial reporting is often necessary. Prior work suggests that firms may be opportunistic in exercising choice and influence where discretion is available to advantageously affect reported results. This study examines if aggressive firms take the opportunity afforded by the wide discretion in Level 3 valuations under the original Accounting Standards Codification (ASC) 820 standard to manipulate financial reporting. Minimal evidence is found to support an association between Level 3 valuations and other metrics reflecting earnings management. The findings may be driven by the high-level, and typically limited, disclosures that firms are required to make under the originally promulgated ASC 820. This primary finding suggests that FASB's move to increase the disclosures required under the standard was warranted.

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Introduction

This study examines if the discretion afforded under Accounting Standards Codification (ASC) 820 – Fair Value Measurements and Disclosures (ASC 820) for valuations that rely on *significant unobservable inputs* is used by firms to alter financial reporting. Standard setters and regulators worry about the impact of managerial discretion on reported results. Among the transactions giving rise to such concerns is fair value accounting and especially Level 3 valuations. As the representation of fair valuation expands within the Codification, the effect of subjective inputs and discretionary aspects of reporting will increase in importance.[1]

The accounting framework, by its very design, involves a tension between *relevance* and *reliability* (Laux & Leuz, 2009). In the interest of *relevance*, some level of discretionary reporting is often necessary.[2] Such is the case when fair values are reported for assets or liabilities where no observable or comparable market price exists and are therefore based on *significant unobservable inputs* (identified as 'Level 3' under ASC 820). The expanded discretion afforded may amplify the opportunity for biased reporting (i.e., a threat to *faithful representation*). Yet, this leeway may be necessary in the interest of relevant reporting. The objective of this study is not to determine to what degree the trade-off is appropriate, but rather to assess if this standard results in opportunistic reporting due to the level of discretion.

Data Availability: XBRL data used in this study are available from Calcbench, Inc. All other data are from public sources identified in the study.

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[1] Efforts surrounding convergence with IFRS have been associated with an increased role of fair value metrics in financial reporting.

[2] Prior to 2010, much of the fair value literature deals with a tradeoff between *relevance* and *reliability*. Reliability refers to a measure that can be validated. In its update of the Conceptual Framework (FASB, 2010a, BC3.20-3.25), FASB replaced *reliability* with *faithful representation*. Faithful representation, in the context of the Conceptual Framework, is used to indicate that the information is complete, neutral, and free from error.

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Assuming aggressively reporting firms seek additional opportunity, the discretion allowed under the current guidance found in ASC 820 may provide another avenue for advantageous reporting. In this study, the association between firm aggressiveness and Level 3 incomes is evaluated. Aggressiveness in financial reporting is assessed in three ways, all of which have been used extensively in past studies. Aggressiveness is measured as (1) the absolute value of prior period discretionary accruals[3,4] (Dechow, Sloan, & Sweeney, 1995; Kim, Park, & Wier, 2012; Kothari, Leone, & Wasley, 2005), (2) composite real activities manipulation[5] (Cohen & Zarowin, 2010; Roychowdhury, 2006), and (3) "Street" earnings that are greater than or equal to analysts' consensus estimates (Matsumoto, 2002; Skinner & Sloan, 2002). Further, both discretionary accruals and real earnings management are estimated using multiple empirical model specifications.

A positive association between the aggressiveness measures and changes in Level 3 valuations recognized in earnings would support the notion that aggressive firms may implement ASC 820 in a way that biases reported financial results. However, the results do not provide conclusive evidence that otherwise aggressive firms report biased (i.e., overstated) gains/losses on Level 3 instruments. Various analyses and robustness tests are conducted: (1) univariate tests, (2) multivariate tests, (3) constraining the analyses to "mark-to-market" adjustments which are recognized in earnings, and (4) a variety of "suspect firm" analyses. Results of the analyses generally do not support the conjecture that earnings are manipulated via the allowable discretion in Level 3 estimates.

The apparent lack of an association is unexpected, particularly in light of the Public Company Accounting Oversight Board's (PCAOB) recommendation of expanded audit evidence in fair valuation situations,[6] suggesting an expectation that these valuations represent an increased audit risk. One potential explanation for the lack of an associative finding is that the standard does not provide sufficiently precise reporting disclosures that are necessary to differentiate between normal and aggressive changes in Level 3 valuations. This assertion is consistent with FASB's ongoing attention to the reporting and disclosure requirements for Level 3 valuations.[7] Specifically, FASB has made nontrivial expansions in the level of valuation disclosures required by management under ASC 820 since its initial release. This suggests that FASB may have realized that the disclosures under the initial ASC 820 were insufficient to provide market participants with adequately useful information. The findings herein indicate FASB's actions were necessary.

Context and motivation

On May 12, 2011, the Financial Accounting Standards Board (FASB) issued a press release stating that the FASB and the International Accounting Standards Board (IASB) completed a significant milestone in the process of moving towards a single, global set of high-quality financial accounting standards via the adoption of common standards governing fair value accounting techniques and disclosures (FASB, 2011a). Despite the world-wide importance of fair value accounting, relatively little empirical evidence exists regarding modern fair value standards. This sentiment is expressed by DeFond (2010): "Going forward, I think there are accounting developments on the horizon about which we know relatively little, and hence are logical prospects for future research. One example is fair value accounting, which represents a potentially sea-changing development in the accounting environment." Additionally, the augmented disclosures required by ASC 820[8] (FASB, 2010b) are thought by some to provide information which may be used to construct more direct tests of managerial discretion in fair value estimates than were possible previously (Barth & Taylor, 2010).

This study examines disclosures under ASC 820 to determine if aggressive firms use the discretion over the inputs used in the Level 3 category[9] asset valuations to report biased (overstated) gains/losses[10] for those instruments. Specific examples of Level 3 items include (1) auction rate securities tied to collateralized student loan debt, (2) investments in hedge funds, (3) investments in private equity firms, (4) collateralized debt obligations, (5) credit default swaps, and (6) derivatives relating to commodity basis differentials. Biased gains/losses may be either unrealized or realized. The unrealized gains/losses used in this study are attributable to Level 3 financial instruments which are not designated as cash flow hedges or represent the ineffective portion of cash flow hedges. These unrealized gains/losses are booked to income statement accounts and affect the current period's earnings. The realized gains/losses attributable to Level 3 holdings are recognized when the item is sold. While it

[3] Discretionary accruals refer to the use of excessively employed accruals with the objective of altering reported results.

[4] A total of seven measures are used because discretionary accruals, while a single category of measure, is assessed in five alternative representations.

[5] Roychowdhury (2006, p.336) defines real activities management as "... management actions that deviate from normal business practices, undertaken with the primary objective of meeting certain earnings thresholds."

[6] The AICPA's issuance of the Clarified Statements on Auditing Standards regarding the evaluation of misstatements identified during an audit, AU-C 450 (AICPA, 2014), also suggests that the existing audit practice surrounding these valuations needed to be enhanced for nonissuers, as well.

[7] See Deloitte's summary of the March 4, 2015 FASB discussion related to the fair value measurement guidance in ASC 820. http://www.iasplus.com/en/publications/us/aje/2015/0305.

[8] FASB's ASC 820: *Fair value Measurements and Disclosures* subsumes the pre-codification standard SFAS 157 (FASB, 2006).

[9] ASC 820 identifies fair value measurement as falling into one of three categories (levels): quoted prices in active markets for identical assets or liabilities (Level 1), (2), significant other observable inputs (Level 2), and (3) significant unobservable inputs (Level 3).

[10] For example, a loss is overstated when a company objectively should have reported a loss of 50 but instead they recognize a loss of 30. Negative 30 is the larger number (i.e., [−30] − [−50] = 20).

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