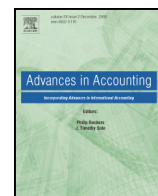




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The effect of the fair value option on bank earnings and regulatory capital management: Evidence from realized securities gains and losses[☆]

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ABSTRACT

Prior research shows that banks achieve reporting objectives using realized securities gains/losses on sales of available-for-sale securities (AFS). Building on this, I investigate whether earnings and regulatory capital management incentives differ between fair value option (FVO) banks and non-FVO banks. FVO banks are allowed to report unrealized gains/losses on elected AFS securities in both current earnings and regulatory capital, whereas, to receive this treatment, non-FVO adopters must sell AFS securities. Using a balanced panel sample covering pre- and post-FVO implementation periods, I find evidence that banks with net positive FVO earnings have fewer earnings and regulatory capital management incentives than do non-FVO banks. My study is of interest to standard setters seeking to reduce earnings and regulatory management behavior, and investors and researchers assessing the implications of the FVO on managers' discretionary actions.

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1. Introduction

I investigate whether net realized gains/losses on sales of available-for-sale (AFS) securities differ between fair value option (FVO) banks and non-FVO banks. Prior research shows that bank managers' incentives to report higher earnings and regulatory capital spur bank managers to sell AFS securities (see e.g., Beatty, 1995; Beatty, Chamberlin, & Magliolo, 1995; Beatty & Harris, 1999; Beatty, Ke, & Petroni, 2002; Collins, Shackelford, & Wahlen, 1995). This activity is motivated by the accounting treatment for AFS under Accounting Standards Codification (ASC) 320 (formerly Statement of Financial Accounting Standards No. 115, *Accounting for Certain Instruments in Debt and Equity Securities*, FASB, 1993). However, under ASC 825 (formerly Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, FASB, 2007), adopters report unrealized gains/losses on elected securities in current earnings. Further, because regulatory capital calculations are based on U.S. GAAP, unrealized gains/losses under the FVO are also included in bank capital while those under ASC 320 are not.

With an alternative accounting treatment, one might therefore expect bank managers to alter their behavior in a FVO environment (Chang, Liu, & Ryan, 2011; Fiechter, 2011; Schipper, 1989). Indeed, the accounting choice literature suggests that changes in accounting standards influence management behavior. The FVO presents an important new setting in which to examine management behavior in relation to reporting

objectives. Consistent with positive accounting theory (Watts & Zimmerman, 1986), Fields, Lys, and Vincent (2001) note that managers choose accounting standards that will yield favorable outcomes. Schipper (1989, 101) points out:

“... regulatory settings offer substantial potential to extend our understanding of earnings management: if a set of regulations leads to a particular form of earnings management, *changes* [emphasis in original] in regulations should lead to predictable changes in earnings management behavior. Tests can therefore be constructed around the intervention in the regulatory force giving rise to earnings management.”

Given that the FVO offers managers an opportunity for an additional source of earnings and regulatory capital through unrealized gains/losses on securities, it potentially reduces incentives for earnings and regulatory capital management.

My study builds on findings of prior banking studies that concern AFS under ASC 320. I employ augmented versions of the net realized securities gains/losses model of Beatty and Harris (1999) using a balanced panel of treatment (FVO banks) and control (non-FVO banks) groups in a pre-FVO period (2005–2006) and post-FVO period (2009–2012).¹ Specifically, I regress net realized securities gains/losses

¹ I seek to isolate net positive FVO earnings effect and reduce the possibility that differences between FVO banks and non-FVO banks are unrelated to economic, systematic, unmeasured, and unrelated factors. A balanced panel of treatment and control banks treats each firm as its own control, resulting in a powerful setting that facilitates stronger internal validity (Cook & Campbell, 1979; Wooldridge, 2010). Hence, my research design reduces differences unrelated to the FVO and controls for macro-economic and regulatory changes, such as the Dodd–Frank Wall Street Reform and Consumer Protection Act (U.S. House of Representatives, 2010).

[☆] Data availability: The data used in this study are available from public sources identified in the text.

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on net income and regulatory capital partitioned on indicator variables representing banks with net positive FVO earnings and net negative FVO earnings, as well as relevant control variables. Consistent with my hypotheses, I find that banks with net positive FVO earnings have fewer earnings and regulatory capital management incentives using net realized securities gains/losses than do non-FVO banks. My main analyses are robust to a number of sensitivity tests. Overall, the results provide some evidence that the FVO has reduced earnings and regulatory capital management incentives.

My study contributes to the accounting literature in some important respects. First, I am the first to explore whether the FVO has reduced managers' discretionary actions among banks. Second, the sample period examined extends the generalizability of the results to settings beyond the FVO implementation period, which is the focus of many extant FVO banking studies. For example, [Chang et al. \(2011\)](#) explore explanations for FVO adoptions and find that opportunistic transition adjustments facilitated banks' reporting objectives during the implementation period. My study provides additional evidence that, post FVO implementation, adopters have fewer incentives for earnings and regulatory capital management but only among banks with net positive FVO earnings. Third, in an international setting, [Black, Sellers, and Manly \(1998\)](#) show that allowing changes in fair values of fixed assets to be included in earnings reduces incentives to sell assets to manage earnings. Alternatively, focusing on financial assets (i.e., AFS securities) among a homogenous sample of U.S. bank holding companies (BHC), which hold more financial assets under the FVO than non-banks ([Guthrie, Irving, & Sokolowsky, 2011](#); [Ryan, 2007](#)), my study provides empirical evidence of reduced earnings and regulatory capital management incentives. Finally, my results are of interest to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board, as they gather and evaluate the FVO's consequences in their efforts to improve financial reporting and advance more fair value accounting standards. Also, investors and researchers can use my results to identify how accounting standard choices can affect management behavior.

The remainder of the paper is organized as follows: [Section 2](#) discusses institutional background and my hypotheses; [Section 3](#) describes the research design; [Section 4](#) reports my sample determination procedures and results; and [Section 5](#) offers concluding remarks.

2. Background and hypotheses development

2.1. Motivation for the fair value option and related research

In response to criticisms from regulators and bank managers over the accounting for securities, the FASB approved ASC 320, which offers separate security classifications with alternative treatments for reported values and fair value adjustments.² The AFS classification has continued to create opportunities for firms to hold assets with unrealized losses and to sell securities with unrealized gains (i.e., gains trading); thus, reclassifying the gains from other comprehensive income to current

² Per ASC 320, investments in debt and equity securities should be classified as trading – with fair value adjustments recorded as unrealized gains/losses in current earnings – if the firm intends to sell them in the near future; debt securities purchased with the ability and intent to hold to maturity should be classified as held-to-maturity (HTM) and recorded at amortized cost; and securities that do not meet the criteria of either trading or HTM should be classified as AFS, which are valued at their prevailing market value with periodic changes in unrealized gains/losses recognized in other comprehensive income. Concerning classifications, regulatory guidelines require significant demands on bank resources that involve increased capacity for stringent risk management practices around trading operations. Requirements on AFS are less stringent. As a result, a limited number of banks utilize the trading classification ([Badertscher, Burks, & Easton, 2012](#); [Barth, 1994](#); [Barth et al., 2014](#); [Ryan, 2007](#); [Song, 2008](#)). In my study, approximately 34 (86) percent of BHCs hold some level of trading (AFS) securities. Untabulated results indicate that the level of trading securities is substantially lower than that of AFS securities. Therefore, it is unlikely that banks were either able or inclined to classify securities as trading for favorable accounting treatment prior to or after the FVO. I thank an anonymous reviewer for raising this issue.

earnings. In February 2007, the FASB issued the FVO (ASC 825), which permits changes in fair values to be recognized as unrealized gains/losses in current earnings rather than in other comprehensive income. Additionally, under ASC 320, calculations of banks' regulatory capital exclude unrealized gains/losses on AFS securities, allowing only realized securities gains/losses to be included in regulatory capital. Unrealized gains/losses on FVO elected securities are included in regulatory capital.

2.2. Investigating sales of securities by banks

Earnings and regulatory capital are critical measures of banks' performance. Realized securities gains/losses represent a common discretionary action used by bank managers to improve these reporting objectives.³ A number of banking studies investigate incentives and motivations that explain how and why bank managers pursue securities sales.

[Beatty et al. \(1995\)](#) analyze the simultaneity of reporting objectives in conjunction with various earnings management techniques and find that, independent of regulatory capital strategies, realized securities gains/losses are used to manage earnings. [Collins et al. \(1995\)](#) provide evidence that bank managers realize securities gains/losses in coordination with raising capital and meeting financial reporting objectives. Additionally, [Beatty \(1995\)](#) finds that earnings and regulatory capital incentives spur realized securities gains/losses in a post ASC 320 environment.

[Burgstahler and Dichev \(1997\)](#) show evidence of asymmetric distributions of earnings decreases and increases and conjecture that investors rely on simple earnings heuristics. [Beatty et al. \(2002\)](#) apply this setting to the banking industry and exploit differences in incentives between public and private banks to investigate earnings management. They show that public banks realize more income from securities sales to manage earnings than do private banks, suggesting the small earnings changes in [Burgstahler and Dichev \(1997\)](#) are attributable to earnings management. [Beatty and Harris \(1999\)](#) show similar evidence that public banks have stronger incentives for earnings and regulatory capital management using net realized securities gains/losses relative to private banks.

Other economic events drive discretionary actions. Bank leverage influences management behavior, as securities are sold to provide liquidity to satisfy current and long-term debt obligations and to avoid bankruptcy ([Cornett, McNutt, & Tenraian, 2009](#)). Also, because outstanding debt serves as a monitoring mechanism ([Jensen & Meckling, 1976](#)), debt holders may be able to limit managers' abilities to pursue their reporting objectives. Firm growth also influences management behavior due to its application to the determination of compensation benefits. Further, [Dechow, Myers, and Shakespeare \(2010\)](#) note that firm growth increases the capacity for opportunistic sales of securities through increased technical abilities of personnel. Prior banking literature also shows minimizing tax costs ([Collins et al., 1995](#); [Scholes, Wilson, & Wolfson, 1990](#)) and reducing agency costs and information asymmetry ([Beatty & Harris, 1999](#); [Warfield, Wild, & Wild, 1995](#)) as reasons for net realized securities gains/losses.

2.3. Hypotheses development

The FVO permits election on an instrument-by-instrument basis. Given that managers have reporting incentives (see e.g., [Beatty et al., 1995](#); [Collins et al., 1995](#); [Beatty & Harris, 1999](#); [Beatty & Liao, 2014](#); [Bushman, 2014](#)), it is likely that they, on average, elect the FVO on securities that yield more favorable outcomes. In a banking setting, [Chang et al. \(2011\)](#) find that FVO adopters exhibited a history of incentives for earnings and regulatory capital management and reported enhanced performance measures during the implementation period. Relatedly,

³ As noted by the American Accounting Association's Financial Accounting Standards Committee (2007), to analyze banks' overall financial condition, banking regulatory authorities employ CAMELS, which is a composite rating system that includes six factors: Capital adequacy (C), Asset quality (A), Management quality (M), Earnings (E), Liquidity (L), and Sensitivity to market risk (S).

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