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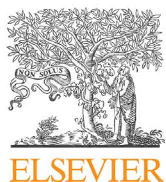

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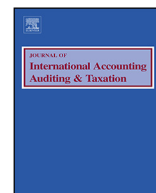

Information content of SFAS 157 fair value reporting

Mohamed A. Elbannan[a], Mona A. Elbannan[b,*]

[a] Department of Accounting, Faculty of Commerce, Cairo University, Orman, Giza 12316, Egypt
[b] Department of Accounting and Finance, Faculty of Management Technology, German University in Cairo, New Cairo City, Cairo 11835, Egypt

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ABSTRACT

This paper examines whether SFAS 157 fair value hierarchy information is associated with stock price synchronicity and whether the relation is moderated by the quality of the firm's information environment. If SFAS 157 information is useful, stock prices of reporting firms should incorporate more firm-specific information and hence exhibit lower synchronicity (measured as the R^2 from a market model regression). The sample consists of 3538 firm-years of listed firms reporting SFAS 157 fair values during the period 2008–2009. Evidence suggests that synchronicity is negatively related to aggregate fair values, that the relation does not monotonically change across the fair value levels, and stock prices of firms with *ex ante* higher quality information environment exhibit weaker differences between fair value levels in their effect on synchronicity. Finally, we further partition the sample into financial and non-financial firms and find that liabilities (assets) are viewed as having a stronger impact on these cash flows than assets (liabilities) in the case of financial (non-financial) firms.

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1. Introduction

FASB holds that the fair value model is more useful for capital market participants than the historical cost model. To this end, SFAS 157 provides a governing framework for the measurement of financial statement elements at fair value although it does not create new accounting rules. In essence, it prescribes three input levels of decreasing reliability for fair value estimation. Level 1 reflects observable market prices for identical assets and liabilities, level 2 reflects observable inputs quoted for similar, not identical, items, and level 3 reflects unobservable inputs for asset or liability valuation models based on managerial estimates and assumptions.

Fair value of assets and liabilities is an example of firm-specific information that, along with industry and market information, is reflected in stock prices. The relative importance of firm-specific, as opposed to market-wide, information in explaining stock prices determines the informativeness of stock prices in the assessment of future cash flows (Morck, Yeung, & Yu, 2000). Recent studies use stock price synchronicity, measured as the R^2 from a market model regression, as an inverse measure of the extent to which firm-specific information is reflected in stock prices (Durnev, Morck, Yeung, & Zarowin, 2003; Morck et al., 2000). A stock price should move asynchronously (synchronously) with the market as it reflects more (less) firm-specific information.

* Corresponding author. Tel.: +20 1008554817.
E-mail addresses: mohamed_abdelsalam@foc.cu.edu.eg (M.A. Elbannan), mona.elbannan@guc.edu.eg (M.A. Elbannan).

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Given the controversy surrounding fair value reporting, this study addresses three research questions related the usefulness of this information. First, we examine the synchronicity effects of aggregate fair value measures. Since SFAS 157 reduces information asymmetry, improves quality of reported information and reduces systematic volatility (*e.g.* Lambert et al., 2007), we expect that firms with higher reported fair values to have firm-specific information represent greater proportion of their stock prices. Second, we examine the incremental synchronicity of the three levels of decreasing reliability. Reporting asset and liability fair values should reduce information asymmetry only to the extent that values are based on observable inputs (*e.g.*, prices quoted in active markets). We expect that synchronicity will be negatively related to the reliability of valuation inputs because investors will differentially value inputs across the three levels. Finally, we examine the role of the quality of the firm's information environment, and expect firms with *ex ante* higher (lower) information environment to exhibit relatively smaller (larger) differences in synchronicity across fair value levels.

To test these hypotheses, we use a sample of 3538 firm-years reporting fair value information during the period 2008–2009. We document four primary findings. First, we find that fair value information increases the incorporation of firm-specific information into stock prices. Second, capital market participants find that levels 1, 2, and, to a lesser extent, 3 assets carry useful firm-specific information. However, empirical evidence points at selective use of fair value levels information by market participants, rather than monotonic change across the levels. Third, we find that differences in synchronicity across the levels are mitigated for firms with more informative disclosure environment, indicating that an informative environment can reduce differential reliability across levels as perceived by market participants. Fourth, the findings of this study show that financial institutions and non-financial institutions are viewed differently by market participants in terms of the relative significance of fair value levels.

This research contributes to the literature in a number of ways. First, this paper extends our understanding of the important informational role that financial reporting plays in the capital markets. Fair value information is essential for capital market participants to understand the nature of the risk exposures associated with financial instruments as well as the success, or otherwise, of an entity in managing financial risks. However, to the best of our knowledge, there is no direct evidence to substantiate the information role of fair value information in a non-financial service setting. Evidence in our study lends support to the informativeness of SFAS 157 requirements in financial as well as non-financial settings. Second, the synchronicity approach employed in this study in assessing the informativeness of SFAS 157 information offers a contrasting view to the price-based approaches predominant in value relevance studies, whose results could be driven by cross-sectional macroeconomic or industry events rather than by gains in investor confidence motivated by firm-specific information (Francis & Schipper, 1999). Third, this study extends Piotroski and Roulstone (2004) by suggesting that fair value information is a determinant of synchronicity that can help reduce information asymmetry. Finally, by exploring the moderating role of the quality of the firm's information environment on the informativeness of SFAS 157 information, this study provides evidence that reliability differences is mitigated for firms with higher quality information environment. The paper proceeds as follows. Section 2 reviews the related literature and develops the hypotheses. Section 3 describes the research design. Section 4 presents empirical results of hypotheses testing, and Section 5 concludes.

2. Background

2.1. Regulatory framework

Fair value has been a longstanding major issue for FASB since 1979, when FASB issued SFAS 33, *Financial Reporting and Changing Prices*, requiring supplemental disclosures of current cost of tangible non-financial assets. Since then, a substantial body of research focusing on fair value accounting has evolved. In September 2006, FASB issued SFAS 157 (ASC 820), *Fair Value Measurements*, which provides authoritative guidance on fair value accounting. While SFAS 157 does not require any new fair value measurements, it defines fair value, establishes a framework for measurement, and expands related disclosures (Financial Accounting Standards Board (FASB), 2006). Prior to this Statement, there were various definitions of fair value and limited guidance for application. In this context, SFAS 157 defines fair value as the (exit) price that would be received to sell the asset or paid to transfer the liability in an orderly transaction between unrelated parties (Financial Accounting Standards Board (FASB), 2006).

In general, fair value accounting has been a matter of controversy. Proponents use substantiating empirical evidence, mostly from value relevance studies, to argue for the increased relevance and reliability of accounting information (Barth, 2004; Landsman, 2006). Opponents argue that fair values increase volatility in firm stock price, are subject to managerial manipulation, and involve high implementation costs and potential to create inflated stock prices (Landsman, 2007; Ryan, 2008). In the midst of this controversy, it is important to question whether SFAS 157 fair value accounting affects the relative importance of firm-specific information, as opposed to market wide factors, in stock prices.

2.2. Prior research, motivation and hypotheses

The financial economics paradigm contends that, in efficient markets, stock prices constantly reflect available firm-specific information, which reduces the association between stock returns and stock market price movements (Gelb & Zarowin, 2002; Roll, 1988). The availability of this information often results in more idiosyncratic information production and less precise private information (Barron, Byard, & Kim, 2002) and leads stock prices to more closely correlate with future

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