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Value relevance of fair values in different investor protection environments



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ABSTRACT

This paper examines whether the value relevance of fair values varies across investor protection environments. By analyzing financial firms from 34 countries this study finds evidence that fair values, irrespective of the level in the fair value hierarchy, are value relevant in countries with a strong or medium investor protection environment. In a weak investor protection environment, only market prices (level 1) are relevant to investors. In addition, the results indicate that the difference in value relevance between market prices (level 1) and fair value estimates (level 3) decreases with the quality of investor protection.

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1. Introduction

This paper investigates the effect of investor protection environments on the value relevance of fair values in the fair value hierarchy as stipulated by IFRS 13.¹ The International Accounting Standards Board (IASB) argues that the management discretion in fair value accounting should be used to increase the relevance of financial information by communicating private information to investors (Barth, Beaver, & Landsman, 2001). However, management discretion in fair value accounting allowed under IFRS can be misused (e.g., negative earnings management, Fargher & Zhang, 2014) by opportunistic managers to increase their wealth at the expense of shareholders (Bowen, Rajgopal, & Venkatachalam, 2008; Dechow, Myers, & Shakespeare, 2010). To meet certain self-interested targets, managers use discretion in goodwill impairment decisions (Beatty & Weber, 2006), estimation of stock option values (Abody, Barth, & Kaznik, 2006; Bartov, Mohanram, & Nissim, 2007), and timely recognition of income and losses (Myers, Myers, & Skinner, 2007). However, the effectiveness of a country's legal system in protecting outside shareholders (i.e., investor protection) limits the managers' ability to misuse accounting discretion (Leuz, Nanda, & Wysocki, 2003). Hence, Leuz et al. (2003) argued that the managers' incentives for opportunistic behaviour decreases with the level of investor protection. Examining the value relevance of fair values in an international setting may offer insights on how investor protection affects the relevance of fair value disclosures. Finally, an international study is relevant as the value relevance of accounting numbers seem to vary across jurisdictions.

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E-mail address: jimi.siekkinen@hanken.fi¹ IFRS 13 was issued in May 12, 2011 and became effective for annual periods beginning on or after 1 January 2013 (IASB, 2011).

Ali and Hwang (2000) showed that the value relevance of accounting numbers is lower for countries with bank-oriented financial systems compared to countries with market-oriented financial systems.² Additionally, DeFond, Hung and Trezevant (2007), among others, find that firms located in stronger investor protection environments have more informative accounting numbers. By comparing the value relevance of US and Italian banks, Laghi, Pucci, Tutino, and Di Marcantonio (2012) show that the fair values under SFAS 157 are more value relevant than the fair values under IFRS 7. They argue that even though SFAS 157 and IFRS 13 can be considered very similar, the economic consequences of the two different standards have to be analyzed more thoroughly. Thus, it is assumed that, although the standards are similar, the value relevance of fair values varies across different investor protection environments and across different financial systems.

Using a sample of 985 firm-year observations from 34 IFRS-countries, the purpose of this study is to analyze whether the value relevance of fair values varies across different investor protection environments. To determine the value relevance of financial statements, the relationship between accounting numbers and share prices is analyzed (e.g., Aharony, Barniv, & Falk, 2010). First, by analyzing the pooled sample of 34 countries, this study finds that fair values in the fair value hierarchy are value relevant for investors. Additionally, the results indicate that fair values are more value relevant than non-fair values, supporting the premise that fair values are value relevant for investors. Second, by splitting the sample into three subsamples depending on the investor protection environment, the results indicate that the value relevance of the fair value estimates is positively associated with the investor protection environment. The stronger the investor protection the smaller the difference in value relevance between levels 1 and 3 fair values. In addition, in the strongest investor protection cluster investors are willing to pay close to equally much for level 1, 2, and 3 assets, while in the medium investor protection cluster investors seem to value level 1 and 2 assets higher than level 3 assets. Hence, in the medium investor protection environments, the investors seem to be skeptical towards the in-house value estimation process of level 3 assets. Finally, only level 1 fair value assets (market prices) are value relevant in the weak investor protection cluster of countries. Fair value estimates are not value relevant in the weak environment.

The remainder of the paper is organized as follows: the following section reviews the literature on value relevance studies, mainly focusing on value relevance studies including fair value accounting or value relevance studies implementing an investor protection approach. The third section presents the sample, descriptive statistics, the investor protection variables included in the cluster analysis, and finally the research design of the study. Section 4 presents the results and the final section concludes the study.

2. Background and previous research

The International Accounting Standards Board (IASB) mandated the new fair value requirements by adopting IFRS 13. IFRS 13 is a joint project between IASB and the Financial Accounting Standards Board's (FASB). FASB mandated their equivalent Financial Accounting Standard No. 157 (SFAS 157) for fiscal periods beginning after November 15, 2007 (FASB, 2006). Both standards require firms to disclose a fair value hierarchy. Based on the data used to measure fair value, the fair value hierarchy is as follows: Level 1 (quoted prices in active markets), level 2 (inputs other than quoted prices that are observable either directly or indirectly, or quoted market prices for similar assets or liabilities), and level 3 (unobservable inputs generated by entities) (IASB, 2011). The information in the fair value hierarchy allows investors to acquire more transparent information about the amounts of the fair value assets and which valuation methods have been used for the specific amount of fair values (Goh, Li, Ng, & Yong, 2015).

The expanding use of fair value accounting in financial reporting has increased the attention of practitioners, academics, and standard setters, causing debate on the usefulness of fair values (Kolev, 2009). Standard setters and the majority of academics claim that fair value accounting provide the most relevant information for investors (e.g., Barth et al., 2001), while opposing academics (e.g., Wallison, 2008) and some practitioners (e.g., Isaac, 2008) blame fair value accounting for the recent financial crisis.³ Hence, there are both positive and negative effects from fair value accounting. On one hand, Fargher and Zhang (2014) find that managers use discretion allowed in fair value accounting to manage earnings that ultimately hurts investors. On the other hand, Baboukardos and Rimmel (2014) show that the discretion allowed in goodwill impairment (i.e., fair value accounting) helps managers to communicate relevant information to equity investors

2.1. Value relevance of the fair value hierarchy

The value relevance of fair values under IFRS 13 has not yet been studied in an international setting. However, due to the adoption of SFAS 157 in year 2007 in the US the effect of the fair value standard has been studied in some content using US data. First, Song, Thomas, and Yi (2010) find that all fair values in the fair value hierarchy under SFAS 157 are value relevant to investors. In addition Song et al. (2010) find that investors place less weight on level 3 fair value assets relative to levels 1 and 2. Further, Goh et al. (2015) extended the study by Song et al. (2010) by increasing the time period of the study and they find that all fair values are value relevant, and that levels 1 and 2 fair value assets are more value relevant than level 3 fair

² Continental Europe countries are classified as having bank-oriented financial systems and British-American countries are classified as having market-oriented financial systems (Ali & Hwang, 2000).

³ A detailed discussion about the fair value accounting debate is provided in e.g., Laux and Leuz (2009).

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