



Conditionally conservative fair value measurements[☆]



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ABSTRACT

Firms measure fair values using Level 2 or 3 inputs when items do not trade in liquid markets, limiting market discipline over the measurements. We provide evidence that firms holding higher proportions of financial instruments measured at Level 2 and 3 fair values report more conditionally conservative comprehensive income attributable to fair value measurements, consistent with firms trying to mitigate investors' discounting of the measurements. We further predict and find that this conditional conservatism (1) increases with governance mechanisms that increase the strength and persistence of firms' incentives to report conservatively and (2) decreases with firms' earnings management incentives.

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1. Introduction

We investigate whether firms' recurring measurements of the fair values of recognized financial instruments (hereafter “fair value measurements”) exhibit conditional conservatism when the instruments do not trade in liquid markets, thereby enabling them to exercise discretion over the measurements.¹ Absent such discretion, fair value measurements should be

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¹ Following Ball and Shivakumar (2005) and Beaver and Ryan (2005), the accounting literature refers to two distinct forms of conservatism: conditional and unconditional. Conditional conservatism involves the timelier recognition of unrealized losses than of unrealized gains. That is, recognition is conditional on the receipt of news and the timeliness of recognition is conditional on the sign of the news received. Unconditional conservatism involves the predetermined (i.e., news-independent) understatement of net assets. Ball and Shivakumar (2005) argue that conditional conservatism has a clear role in contracting, whereas unconditional conservatism yields uninformative biases. Beaver and Ryan (2005) show that unconditional conservatism preempts conditional conservatism, so that the two types of conservatism, while conceptually distinct, are empirically interrelated.

unbiased, i.e., symmetrically incorporate unrealized gains and unrealized losses. Policymakers and academics often make statements or research design choices that suggest fair value measurements generally are unbiased, ignoring biases introduced by discretion. For example, SEC (2008) states that the “objective of SFAS No. 157 and of existing fair value standards is to provide transparent *unbiased* information about fair value.” Shaffer (2011) describes fair value measurement as “an anchor for”...“an asset/liability approach... [in which] valuations must be objective and neutral. This requirement *overrides the constraint of conservatism*, which historically assumed a downward bias for asset valuations.” (Emphasis added in both quotes.) Empirical research examining fair value measurements' predictive power and their value-, returns-, and risk-relevance often sums fair values or fair value gains and losses, which is appropriate only if the summed items are measured comparably (e.g., are unbiased or have the same proportional bias).²

Ostensibly in contrast to the view that fair values are unbiased, some influential observers claim that fair value measurements for instruments that do not trade in liquid markets represent optimistic or noisy “mark-to-myth” (Buffett, 2003) or “mark-to-make-believe” (Weil, 2007) valuations that are discounted by investors. Empirical research provides evidence supporting these claims (Kolev, 2009; Song et al., 2010; Goh et al., 2009). To mitigate such discounting, we expect firms to take steps to increase the perceived reliability of these measurements. The step we examine is suggested by the extensive literature that documents the contracting and other benefits of conditional conservatism (e.g., Basu, 1997; Watts, 2003). Roychowdhury (2010) emphasizes the critical role of explicit and implicit governance mechanisms, which increase the strength and persistence of firms' incentives to report conditionally conservatively, to obtain these benefits. Although firms make reporting decisions each period, when these incentives are sufficiently strong and persistent, they effectively constitute a “credible commitment” to conditional conservatism (e.g., Zhang, 2008).

We identify the extent of firms' discretion over fair value measurements using disclosures provided under Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements* (FASB, 2006). This standard requires firms to disclose, for each major category of asset and liability, the fair value measurement amounts that are based on active market prices for the items being measured (Level 1 inputs), other observable information (Level 2 inputs), or unobservable information (Level 3 inputs).³ These three input levels differ in their *observability* and individual *completeness* as measures of fair value, and thus in the extent of discipline they provide over firms' fair value measurements. Level 1 inputs are both observable and individually complete measures of fair value, and thus provide a very high level of discipline over fair value measurements. Level 2 inputs are observable but individually incomplete measures of fair value, requiring either adjustments to observed market prices for the illiquidity or dissimilarity of the items being fair valued or model-based calculations involving other inputs to determine fair values. Level 3 inputs are both unobservable and individually incomplete measures of fair value. We refer to Level 2 or 3 inputs or fair value measurements based on these inputs as “lower-level”.

We predict that firms mitigate investors' discounting of lower-level fair value measurements by reporting the measurements conditionally conservatively, i.e., by recognizing unrealized losses in a timelier fashion than unrealized gains. We further predict that firms report more conditionally conservative fair value measurements when the measurements are evaluated by more knowledgeable investors, verified by more independent third parties, and disclosed more fully in financial reports, governance mechanisms that increase the strength and persistence of firms' incentives to report conditionally conservatively. Lastly, we predict that firms that narrowly meet or beat earnings targets, an earnings management incentive that typically conflicts with conditional conservatism, report less conditionally conservative fair value measurements.

To test these predictions, we measure conditional conservatism using two expanded versions of Basu's (1997) approach.⁴ The dependent variables in these expanded models are the portions of comprehensive income (CI) attributable to fair value measurements of financial instruments (FVCI) and the remainder of CI (CI–FVCI). We interact the proportions of fair value measurements at the various levels with the explanatory variables in recent implementations of Basu's (1997) approach. Consistent with the discussion above, we expect firms with higher proportions of Level 2 and 3 fair value measurements, but not those with higher proportions of Level 1 measurements, to exhibit more conditionally conservative FVCI.

In contrast, we do not expect any association between the fair value measurement level proportions and the conditional conservatism of CI–FVCI. Although CI–FVCI includes any conditionally conservative fair-value-based impairment write-downs of tangible and intangible assets (Ramanna and Watts, 2012; Roychowdhury and Martin, 2013), there is no apparent reason why the frequency or size of these *non-recurring* write-downs should vary with the proportions of recognized financial instruments measured at the various fair value levels on a *recurring* basis. In this regard, the analysis of CI–FVCI constitutes a placebo test.

To test our predictions about variation in incentives to report conditional conservative Level 2 and 3 fair value measurements across firms and time, we compare the conditional conservatism of FVCI across four partitions of the full sample.

² For example, the studies examining the value-relevance of SFAS 157 fair value measurement-level disclosures discussed in Section 2 exhibit such features.

³ SFAS 157 was incorporated into the FASB's Accounting Standards Codification (ASC), Topic 820, in 2009. The FASB amended Topic 820 in 2010 through Accounting Standards Update No. 2010-06 – *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, and in 2011 through Accounting Standards Update No. 2011-04 – *Fair Value Measurement Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. These amendments involved fairly subtle changes to fair value measurements and disclosures that do not affect our hypotheses or empirical analysis.

⁴ We discuss the assumptions and limitations of Basu's (1997) approach and why we apply this approach to our research question in Section 3.

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