



# Fair value measurement capabilities, disclosure, and the perceived reliability of fair value estimates: A discussion of Bhat and Ryan (2015)



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## ABSTRACT

Selecting an appropriate measurement basis for financial reporting is a fundamental and contentious accounting policy issue. While many argue that fair value is the most relevant measurement basis for financial reporting, other observers express concerns about the reliability (or “faithful representation”), and thus the usefulness, of fair value measurements. Bhat and Ryan (2015) consider the role of risk management technologies—in particular, market and credit risk modeling—in the estimation of fair values. In light of our discussion of Bhat and Ryan’s study, we argue that future research should aim to extend our understanding of the fair value estimation process and the factors that explain variation in the reliability of fair values as well as the channels through which investors learn about fair value measurement reliability.

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## 1. Introduction

Measuring and reporting fair values of assets and liabilities has long been a topic of substantial debate among academics, policy-makers, and practitioners (see, e.g., Laux & Leuz, 2009 and Hodder, Hopkins, & Schipper, 2014). A central theme of the fair value debate is the tradeoff between the two fundamental qualitative characteristics of accounting information: relevance and reliability.<sup>1</sup> Advocates argue that fair value is the most relevant measurement attribute for financial reporting purposes because it increases transparency by providing more timely information. In contrast, critics contend that some fair value measurements are not useful to investors because the reliability of these estimates is diminished

when they are susceptible to manipulation, prone to estimation error, and/or difficult to verify.<sup>2</sup>

Academic researchers have contributed to the fair value debate, in part, by determining whether and to what extent fair value measurements are relevant to investors for valuation. In tests of value relevance, which are joint tests of both relevance and reliability, capital market researchers commonly examine associations between fair value measurements and equity values (e.g., Barth, 1994; Barth, Beaver, & Landsman, 1996; Beaver & Venkatachalam, 2003; Nelson, 1996; Petroni & Whalen, 1995; Venkatachalam, 1996).<sup>3</sup> Value relevance studies document estimated regression coefficients that are often smaller in magnitude than their theoret-

<sup>2</sup> The bias (noise) injected into financial reports as a result of unobservable managerial manipulation (estimation error) in determining fair values is particularly problematic when investors are unable to discern the direction and magnitude of misreporting, as in Fischer and Verrecchia’s (2000) analytical model.

<sup>3</sup> Value relevance studies examine the relation between accounting information and stock prices or changes in prices (i.e., returns). An accounting number is considered value relevant if the regression coefficient is statistically different from zero and has the correct sign. Fair values of assets (liabilities) have predicted regression coefficients of 1 (–1); these predicted coefficients are theoretical benchmarks based on making certain underlying assumptions. We refer readers to Holthausen and Watts (2001), Barth, Beaver, and Landsman (2001); and Landsman (2007) for reviews of the value relevance literature.

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<sup>1</sup> The Financial Accounting Standards Board (FASB) recently replaced the term “reliability” with “faithful representation” (FASB, 2010). We use these terms interchangeably throughout our discussion in a way that is intended to be consistent with prior use of the term “reliability” in the academic literature and the commonality between the FASB’s definitions of both terms.

ically predicted values, suggesting that investors price some fair value estimates at a discount. Variation in equity valuation multiples is generally consistent with differences in the perceived reliability of fair value estimates. In particular, pricing discounts are primarily observed in the context of unverifiable fair value estimates that are sensitive to managerial discretion over valuation inputs, measurement error, or both. Consequently, fair value estimates may not be fully impounded in stock prices because investors' assessments of relevance are confounded by their perceptions of measurement reliability (e.g., Kadous, Koonce, & Thayer, 2012). Opportunities to contribute to this literature, therefore, include isolating the underlying sources of variation in the reliability of fair value measurements. Bhat and Ryan (2015) provide such a study by attempting to link firm-specific technologies to the estimation of fair value measurements.

Bhat and Ryan consider risk management technologies as potential inputs in the fair value estimation process. In particular, they assess whether market and credit risk modeling by financial institutions enhances the relation between stock returns and estimated unrealized fair value gains and losses on financial instruments. Estimated fair value gains and losses are assigned to one of three categories based on financial reporting treatment: (1) amounts recorded in net income, (2) amounts recorded in other comprehensive income, and (3) amounts disclosed in the notes. Fair value gains and losses recorded in note disclosures (and, to some extent, in other comprehensive income) are assumed to be less reliably measured than amounts recorded in net income. Bhat and Ryan conjecture that banks' market and credit risk modeling techniques can improve the usefulness of fair value measurements suffering the most from reliability concerns, thus attenuating the pricing discount applied by investors to account for measurement error and bias. For their sample of 238 banks from 2002 to 2013, the authors conclude that market and credit risk modeling generally improves the association between stock returns and estimated fair value gains and losses recorded in other comprehensive income and in note disclosures.

Below we begin by framing Bhat and Ryan's study in the context of the extant literature, particularly with respect to studies examining the value relevance of fair value measurements. We then discuss some of Bhat and Ryan's research design choices and possible alternative explanations to consider when interpreting their results. Throughout our discussion, we offer suggestions for future research that can push the fair value literature forward, in part by addressing some of the inherent limitations encountered in this study.

## 2. What is the contribution of the paper?

### 2.1. Value relevance and fair value measurements

An empirical challenge in the fair value literature is to identify settings that allow researchers to disentangle the constructs of relevance and reliability. Koonce, Nelson, and Shakespeare (2011) use experimental methods to isolate and directly study investors' beliefs about the relevance of fair values for financial instruments, while holding constant measurement reliability and other characteristics. Archival studies, however, generally assess the differential value relevance of fair value measurements by examining cross-sectional variation in the perceived reliability of those estimates, while assuming a minimum level of relevance. Song, Thomas, and Yi (2010), for example, consider how the value relevance of fair value estimates varies predictably with respect to the source of estimation inputs. According to the hierarchy established by Statement of Financial Accounting Standards No. 157 (now Accounting Standards Codification 820), Level 1 and 2 fair value measurements are derived from observable valuation inputs based on

quoted prices in active markets (FASB, 2006). In contrast, Level 3 fair value estimates are sensitive to unobservable valuation model assumptions that are subject to managerial discretion and estimation error. Consistent with Level 3 estimates likely being less reliably measured than Level 1 and 2 estimates, the authors find that the estimated coefficients from price level regressions are larger for Level 1 and 2 fair value measurements than for Level 3 estimates (see also Goh, Li, Ng, & Yong, 2015). Furthermore, they find that stronger corporate governance improves the association between stock price and Level 3 fair values, suggesting that effective corporate governance can mitigate investors' concerns about measurement reliability.

### 2.2. Risk modeling, fair value gains and losses, and stock returns

Bhat and Ryan's study complements the extant literature in several ways. First, to proxy for fair value measurement reliability, they examine variation in the recognition and placement of fair values in financial statements, rather than variation in the source of information used to estimate fair values (e.g., estimates based on Level 1, 2, and 3 valuation inputs). They argue that fair value gains and losses recorded in note disclosures (and, to some extent, in other comprehensive income) correspond to financial instruments that trade in illiquid (or "thin") markets and, therefore, are more likely to be less reliably measured than fair value gains and losses recorded in net income. Second, the authors consider a relatively unexplored mechanism for reliability enhancement—i.e., market and credit risk modeling techniques. Following the recent financial crisis, risk management technologies, such as risk modeling, have become an increasingly important aspect of corporate decision making, particularly within financial institutions. Improving our understanding of the role of risk management technologies in, for example, the estimation of fair values is an important area of research. Third, Bhat and Ryan use an extended and more heterogeneous sample period than the samples used in prior studies, providing opportunities for the authors to conduct subsample tests that emphasize the importance of market and credit risk modeling in certain contexts such as the 2008 financial crisis.

Some of their conclusions, however, are open to alternative explanations. For example, it is unclear whether their results are driven by a reduction in information asymmetry resulting from the choice to disclose information about risk modeling activities or by the risk modeling activities themselves. In particular, as we will discuss below, it is difficult to disentangle the role of risk management technologies in the estimation of fair values from the impact of disclosures on investors' perceptions of fair value measurements.

## 3. Comments on empirical tests and on opportunities for future research

### 3.1. Risk modeling quality and the reliability of fair value measurements

Bhat and Ryan's results provide interesting insights into the role of internal risk modeling techniques in the measurement of complex fair value estimates. For instance, based on the results reported in Panel A of Table 4, Bhat and Ryan conclude that market risk models improve the measurement of fair value gains and losses recorded in other comprehensive income, while credit risk models predominantly improve the measurement of fair value gains and losses disclosed in the notes. An empirical limitation, however, is that the authors make assumptions about variation in the quality (and intensity) of risk modeling and the reliability of fair value measurements. For example, the authors assume that the quality of risk modeling is generally uniform across banks with the

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