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FAIR VALUE ACCOUNTING: INFORMATION OR CONFUSION FOR FINANCIAL MARKETS?

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The recent financial crisis has led to a critical evaluation of the role that fair value accounting "...the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date..." may have played in undermining the stability of the financial system. Reacting to the pressures of banking regulators and governments, standard-setters have brought forward additional guidance on the application of fair value accounting. This paper examines if and how fair value reporting by U.S. commercial banks during the 1996-2009 period influences the quality of information used by financial analysts. Our results show that, overall, the greater the extent of a bank's assets and liabilities reported at fair value, the more dispersed are analysts' earnings forecasts. Moreover, as the proportion of assets measured at fair value increases, properties of analysts' forecasts become less desirable, showing a decrease in the precision of public or private information. The informational properties of fair value disclosure decrease as we move from level 2 to mark-to-model data (level 3). Nevertheless, additional analyses suggest that the disclosure of levels has been beneficial to investors as it enhanced private information precision resulting in more accurate and less dispersed analysts' forecasts. Finally, the disclosure about the valuation of assets that are measured at fair value on a non-recurring basis reduces accuracy and public information precision while enhancing dispersion.

The study is subject to some limitations. First, financial analysts are but one class of financial information users and their actions and behaviours may not be reflective of decisions by other users such as individual or institutional investors. However, there is extensive empirical research that suggests that financial analysts play an important role in financial markets and that, as such, their actions are relevant and potentially representative of market sentiment as a whole. Second, the period under investigation may or may not be appropriate to gauge the informational properties of fair value disclosure. However, SFAS 157 and SFAS 159 were only enacted in 2006 and could be implemented at the earliest in 2007. Moreover, financial reporting is designed only for fair-weather financial and economic conditions: in some sense, the 2007-2009 period constitutes a stress test of the impact of new fair value measurement and disclosure standards on financial markets.

Future research could extend and compare the impact and consequences of fair value measurement and disclosure among U.S. banks with Europe and/or Asian banks. The impact of bank governance on the informational properties of fair value information could also be investigated further.

The report is available on the CIRANO website at the following address:
http://www.cirano.qc.ca/pdf/publication/2011s-56.pdf