Analyst Coverage, Market Liquidity and Disclosure Quality: A Study of Fair-value Disclosures by European Real Estate Companies Under IAS 40 and IFRS 13

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A B S T R A C T

Disclosures in notes have been criticized by practitioners for being unwieldy and contributing little to the quality of the financial information. This study presents evidence on the association between disclosure quality, analyst following and liquidity in the real estate sector. More specifically, we study the disclosure of the methods and significant assumptions applied in determining fair values of investment properties under IAS 40 and IFRS 13. We find that disclosure quality is significantly higher under IFRS 13. Furthermore, we show that the quality is associated with analyst following and bid-ask spreads. However, the improved disclosures following the adoption of IFRS 13 are not associated with any significant positive economic consequences. This result indicates that the revised disclosure requirements in IFRS 13 did not solve any market imperfections.

1. Introduction

This study has two purposes: the first one is to investigate whether the quality of fair value disclosures for companies in the real estate sector improved with the adoption of IFRS 13. The second one is to examine the economic consequences of disclosure quality through an examination of its association with analyst following and market liquidity.

International Accounting Standard (IAS) 40 regulates the accounting for investment properties; the key feature being that fair values of investment properties have to be reported on the balance sheet or disclosed in the notes. The fair value measurement is either based on market approaches or income approaches (discounted cash flows). Measurements of investment properties are basically Level 2 or 3 measurements in the fair value hierarchy (PwC, 2011). However, in this study we focus on companies reporting fair values on their balance sheets using an income approach (i.e. Level 3).

Level 3 fair values have been criticized for being vulnerable to manipulation and less value-relevant than Level 1 and 2 (e.g., Aboody, Barth, & Kaznik, 2006; Bernston, 2006; Hitz, 2007; Song, Thomas, & Yi, 2010). Reliability concerns increase information asymmetry and result in adverse selection problems. In the absence of credible and verifiable information, investment property companies with different quality properties may be valued similarly by investors because they do not have the necessary information to discriminate. One solution to this problem is that companies disclose their valuation assumptions so that they can be verified by

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third parties (Landsman, 2007).

Guidance on fair value measurement and disclosure has been included in IFRS 13 since the beginning of 2013. The former requires in IAS 40 were much less detailed than the current ones in IFRS 13. In essence, IAS 40 only included a sentence requiring the disclosure of “the methods and significant assumptions applied in determining the fair value of investment property...” (IAS 40:75d), whereas IFRS 13 includes more detailed application guidance. There is a discussion among academics and practitioners about the pros and cons of detailed rules in accounting standards (e.g., European Financial Reporting Advisory Group, 2012; Nelson, 2003; New Zealand Institute of Chartered Accountants and the Institute of Chartered Accountants of Scotland, 2011; Nobes, 2005; Schipper, 2003; Sunder, 2010). Proponents of detailed guidance claim that it increases comparability, verifiability and reduces opportunities for earnings management (Schipper, 2003). However, more detailed disclosure requirements inevitably mean that financial reports will be longer and more complex. The European Financial Reporting Advisory Group (2012, p. 6) points out that: “There is a strong consensus in the financial community that disclosures in the notes to the financial statements have become unwieldy; the increasing length of the notes has done little to improve the quality of information, and may have even decreased it because of information overload.”

Furthermore, a joint working group of the Institute of Chartered Accountants of Scotland and the New Zealand Institute of Chartered Accountants claim that it is time to discard the excess baggage and reduce the disclosures in financial statements to only those which are important (New Zealand Institute of Chartered Accountants and the Institute of Chartered Accountants of Scotland, 2011).

Voluntary disclosure is an alternative to disclosure regulation and the economics based literature suggests that regulation can be defended if it solves market imperfections (e.g., Beyer, Cohen, Lys, & Walther, 2010; Healy & Palepu, 2001). Disclosures in a regulated setting are also influenced by voluntary choices. Disclosure requirements differ in their detail and a standard with less precise guidance leaves more room for judgment by managers. Thus, actual disclosures are a product of a company’s compliance with mandatory requirements and its voluntary disclosure choices within the limits of the requirements. IFRS 13 leaves less room for judgment by managers, implying that the mandatory disclosure component is more significant under IFRS 13 than under IAS 40.

A first purpose of the study is to examine whether companies disclose more under IFRS 13 than under IAS 40. Next, we examine whether disclosure quality is associated with analyst following and market liquidity. The examination of market liquidity follows the suggestion that a greater disclosure of relevant items reduces information asymmetry and thereby increases liquidity (Verrechia, 2001). The impact of fair value disclosures on analyst following and market liquidity is far from obvious. On the one hand, higher quality fair value disclosures may reduce information asymmetry problems and thereby increase analysts’ incentives to follow a company and investors’ willingness to invest. On the other hand, there is a concern that readers will be blinded by so much data in financial reports that the main messages will be lost (New Zealand Institute of Chartered Accountants and the Institute of Chartered Accountants of Scotland, 2011). Finally, we study whether regulation has a role by examining whether companies providing greater disclosure under IFRS 13 than under IAS 40 experience any positive economic consequences in the form of increased analyst following or market liquidity. Overall, this study contributes to the literature by providing new empirical evidence on how companies disclose under the less detailed IAS 40 and the more detailed IFRS 13.

Our study extends the literature on the economic consequences of disclosure quality by examining the impact of disclosures in the notes of the financial statements on analyst following and market liquidity. Prior studies of the association between disclosure quality and liquidity have focused on disclosure quality according to analysts’ perceptions of disclosure quality (e.g., Healy, Hutton, & Palepu, 1999; Welker, 1995) and IAS/IFRS adoption (e.g., Christensen, Hail, & Leutz, 2013; Daske, Hail, Leuz, & Verdi, 2008; Muller, Riedl, & Sellhorn, 2011). Muller et al. (2011) study the impact of fair value disclosures on bid-ask spreads in the real estate sector. Their study is closely related to our research, although an important difference is that they study the impact of fair value disclosures using a pre/post IAS/IFRS research design, whereas we study the impact of disclosure quality for firms following IAS/IFRS.

However, although the research reviewed above indicates that the overall disclosure quality improves market liquidity, it does not provide any guidance as to which types of disclosures mandated by IAS/IFRS standards are associated with market liquidity. The only published study we are aware of in which the economic consequences of specific disclosures are studied is that of Paugam and Ramond (2015), who examined the association between impairment testing disclosures and the cost of capital. Another study that is related to ours is that conducted by Vergauwe and Gaeremynck (2014), who study the reliability effects of fair value disclosures on a sample of real estate companies.

Overall, our research contributes to the literature on fair value accounting (e.g., Barth, 2007) and to research on factors associated with disclosure quality under IFRS (e.g., Glaum, Schmidt, Street, & Vogel, 2013; Kvaal & Nobes, 2010, 2012) by examining arguably important fair value disclosures that have received very little attention in the literature. Furthermore, our study is related to research on investment properties, which among other things has focused on the choice between the cost and fair value models (Quagli & Avallone, 2010), the impact of audit quality and the use of external valuers on information asymmetry (Muller & Riedl, 2002), the reliability of investment property fair values (Dietrich, Harris, & Muller, 2001) and the value relevance of recognised versus disclosed fair values (Muller, Riedl, & Sellhorn, 2015). Our study adds to this literature by providing evidence on factors associated with disclosure quality, as well as the economic consequences of fair value disclosures.

The empirical analyses are based on a small but homogeneous sample of listed real estate companies in the EU. The sample consists of 289 observations for 57 companies and covers the period 2009 to 2014. For inclusion in the sample, each company has to apply the fair value model under IAS 40, use an income approach (discounted cash flows) as its valuation technique and have

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1 IASB is currently also working on a new approach to draft disclosure requirements. See IASB Agenda ref. 11A, published in September 2015 (available at: http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/September/AF11A-Disclosure-Initiative.pdf).
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