



# Fair value accounting for non-current assets and audit fees: Evidence from Australian companies



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## ABSTRACT

We investigate the association between asset revaluations of non-current assets and audit fees, using a sample of ASX 300 companies from the years 2003–2007. We report that there is a significant increase in the audit fees paid when non-financial assets (PPEs, investment properties and intangible assets) are measured at fair values. Moreover, we provide evidence that an independent valuer or appraiser significantly weakens the positive association between asset revaluations and audit fees. Furthermore, companies whose non-current assets are revalued upwards and those that revalue their non-current assets upwards every year have significantly higher audit fees. Additional tests provide empirical evidence that the strength of corporate governance has a moderating effect on the level of audit fees. This study contributes to the ongoing debate on the role of fair value accounting. The findings suggest agency costs associated with fair value estimates may offset the benefits from the use of fair value accounting.

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## 1. Introduction

Since the global financial crisis, considerable debate has focused on fair value accounting for financial assets in the banking industry (Barth and Landsman, 2010; Landsman, 2007; Laux and Leuz, 2009). However, there is a lack of evidence on the costs and benefits of using fair values for the non-financial asset groups<sup>1</sup> – property, plant and equipment (PPE), investment property, and intangibles, a context where managers have a choice between the use of historical cost or fair values. We follow Goncharov et al. (2013) and Ettredge et al. (2013) to study audit fees that represent a major agency cost in relation to the valuation practices for such assets.

The International Financial Reporting Standards (IFRS) adopted in Australia from 2005 allow a choice between the use of fair value and historical cost for PPE and investment property and, if an active market exists, for intangibles.<sup>2</sup> The Financial Accounting Standards Board (FASB) acknowledges that active markets for some assets are relatively uncommon, meaning fair values have to be ascertained by a third party using valuation techniques and estimations. Valuation of illiquid non-financial assets may not be based on direct observations of transactions or a quoted market price in an active market that offers superior reliability (Christensen and Nikolaev, 2013). The choice of fair values could increase audit fees and/or auditors' efforts since fair value accounting increases the difficulty of verifiability and complexity (Ettredge et al., 2013). Even observed prices may introduce uncertainty to auditors, especially in distressed markets (Bratten et al., 2013). In addition, Kumarasiri and Fisher (2011) found that auditors are generally not

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<sup>1</sup> The terms “non-financial assets” and “non-current assets” are used interchangeably throughout the paper when it is appropriate. That is, when we are discussing non-financial assets which are also non-current assets.

<sup>2</sup> An active market rarely exists for intangibles and hence the managerial choice of valuation policies for intangibles cannot be considered as for PPE and investment property.

knowledgeable enough to ascertain fair value estimates. Moreover, fair values can lead to higher audit fees and/or risks as they increase agency costs. As the fair value model for non-financial assets requires numerous inputs and models based on managerial assumptions, estimation uncertainty exists and active markets do not exist. Therefore managers have opportunities to manipulate earnings (Bratten et al., 2013; Fiechter and Meyer, 2009; and others<sup>3</sup>).

We provide a number of tests using a sample of ASX 300 companies from the years 2003–2007. First, we investigate the association between audit fees and valuation choices for non-current assets (i.e. fair values or historical costs). We find that there is a significant increase in the audit fees paid when non-financial assets, PPEs, investment properties and intangible assets are measured at fair values (or using the 'revaluation model'). The results imply that fair value measurement for non-current assets increases audit fees by either reducing audit efficiency<sup>4</sup> or increasing audit risks due to increased agency problems.

Second, we test the association between the use of fair value for non-financial assets and audit fees in a number of settings where agency problems might be more or less severe – use of director-based valuations, occurrence of upward revaluations and the frequency of upward revaluations. We find that (i) an independent valuer or appraiser significantly weakens the positive association between asset revaluations and audit fees. This finding suggests that the use of external independent appraisers, who have fewer incentives than internal directors to take advantage of fair value for earnings management, reduces the predicted audit fees and/or risks; (ii) companies whose non-current assets are revalued upwards incur higher audit fees; and (iii) companies that revalue their non-current assets upwards too regularly have significantly higher audit fees.

Finally, additional tests provide evidence that the magnitude of audit fee changes in relation to asset revaluations is dependent on the strength of corporate governance mechanisms. Specifically, results show that good corporate governance (e.g. audit committee independence and board member accounting expertise) can reduce audit fees in the context of upward asset revaluations. However, weak corporate governance (e.g. duality, being both chairperson of the board and CEO) reduces the reliability and exacerbates agency issues associated with fair value estimates, leading to higher audit fees. A battery of robustness checks has been conducted including (a) using alternative measures of audit fees and (b) eliminating the effect of adoption of IFRS in 2005. These robustness checks provide consistent results.

This study contributes to both the fair value accounting and audit fee literatures as follows. First, a few recent studies (e.g. Ettredge et al., 2013; Goncharov et al., 2013) have examined the association between fair value accounting

choices and audit fees, focusing on financial assets in the financial sectors. These assets are largely exposed to fair value accounting and were significantly affected during the 2007–2008 global financial crises. However, the results in those studies remain inconsistent. For example, Ettredge et al. (2013), using a sample of US bank holding companies from 2006 to 2008, found that audit fees increased as the proportion of fair valued assets increased in the US banking industry. On the other hand, using a sample of European real estate firms after IFRS adoption, Goncharov et al. (2013) provided evidence that audit fees are economically and statistically lower in firms reporting higher proportions of property assets at fair value. We extend this branch of studies by focusing on illiquid non-financial assets that are arguably more problematic with respect to fair value measurements.

Second, we contribute to the body of knowledge on the costs and benefits of fair value accounting. Since the 2007–2008 global financial crisis, critics have argued that fair value accounting for financial instruments exacerbated the severity of the 2007–2008 financial crisis (Laux and Leuz, 2009). However, there is still a lack of evidence on the costs and benefits of valuation practices for the non-financial asset groups, PPE, investment property, and intangibles. Prior studies suggest that fair value accounting can enhance both the decision and contracting usefulness of financial statements, but results from this study reveal that implementing fair value accounting increases agency costs, which is ultimately reflected in the level of audit fees paid.

Finally we provide empirical evidence that the strength of corporate governance has a moderating effect on the reliability of fair value estimates, which is of interest not only for managers but also regulators and practitioners.

The paper is organised as follows. Section 2 outlines the institutional background for asset revaluations in Australia. Section 3 reviews the related literature and Section 4 develops the hypotheses of the study. Section 5 outlines the sample, specifies the regression models and the variables used in the model. Section 6 presents the analysis of the results. Section 7 summarises the additional tests and reports the robustness tests. Section 8 concludes and addresses the limitations of the study.

## 2. Institutional background

In Australia, the manager of a firm has discretion in the use of asset revaluations. Asset revaluation refers to the act of recognising a reassessment of the carrying amount of a non-current asset to its fair value as at a particular date. Prior to 2005, the accounting standard for revaluation of assets was Australian Accounting Standards Board (AASB) 1041 *Revaluation of Non-Current Assets*. Now there are three accounting standards, AASB 116 *Property, Plant and Equipment*, AASB 138 *Intangible Assets*, and AASB 140 *Investment Properties*.

(i) Paragraph 29 of AASB 116 states:

*An entity shall choose either the cost model in paragraph 30 or the revaluation model in paragraph 31 as its accounting policy and shall apply that policy to an entire class of property, plant and equipment.*

<sup>3</sup> See Henry (2009); Barth (1994); Hodder et al. (2006); Li and Sloan (2009); Song (2008); Fargher and Zhang (2012); Ramanna and Watts (2009); Dechow et al. (2010); Shalev et al. (2013); Livne et al. (2011).

<sup>4</sup> There are difficulties associated with the variation in techniques used to ascertain fair values across different industries and general complexities in ascertaining fair values.

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