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An Analysis of the Usefulness to Investors of Managers' Fair Value Estimates of Firm Assets: Evidence from IAS 36 "Impairment of Assets" and IAS 40 "Investment Property"

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Firms' adoption of the International Financial Reporting Standards (IFRS) has been increasing worldwide. Even the U.S. Securities and Exchange Commission is considering direct incorporation of IFRS into the U.S. financial reporting regime in the foreseeable future. With the adoption of IFRS, reports of managers' fair value estimates of a firm's assets in financial statements became more pervasive than under local generally accepted accounting principles (GAAPs) and is likely to become increasingly important over the coming years. However, managers' fair value estimates are subject to measurement errors that might reduce the faithful representation of accounting numbers. Using publicly available managers' fair value estimates of cash generating units (CGUs) and investment properties, this empirical study analyzes the usefulness to investors of these estimates. This study conducts three standalone capital market based analyses of which two are related to IAS 36 "*Impairment of Assets*" and one is related to IAS 40 "*Investment Property*."

To estimate IAS 36 impairment losses, managers need to define CGUs, project future net cash flows from the CGUs, and estimate discount rates that reflect the risk of the CGUs. Thus, there is substantial managers' discretion in estimating impairment losses.

The first study provides evidence that a stringent reporting environment restricts managers' use of discretion in identifying CGUs opportunistically and induces them to use discretion prudently to avoid the overstatement of assets. In addition, some evidence is provided that a stringent reporting environment can encourage managers to adjust assets to account for economic losses previously unaccounted for, to understate assets, and to adjust assets frequently. Overall, the results provide evidence that managers' various uses of discretion reduce the comparability of operating performance across firms and time periods. Increasing the comparability of firms' operating performance is one of the IASB's major goals.

In the second analysis, evidence is provided that impairment charges estimated in the absence of managers' opportunistic behavior reduce only in part investors' uncertainty about a firm's asset quality when investors are not well informed by analysts. When investors are well informed by analysts, the results imply that the information content of nonopportunistic impairment losses is completely anticipated. The findings might be driven by the fact that managers provide little or no new information to investors to reduce a firm's direct and indirect (proprietary) costs to sustain current and future earnings. Thus, not only managers' opportunistic behavior—that is likely of interest to managers only—but also managers' cost considerations can reduce the informativeness of impairment losses.

The results of the first two studies provide some evidence that the requirements set forth in IAS 36 are ill-advised. To change the standard effectively, more research is needed that analyzes the costs and benefits of discretionary impairment guidelines.

While the IASB allows firms to report IAS 40 fair value increments (above historical costs) and decrements, the U.S. FASB requires firms to report investment properties at historical cost. Under the historical cost model, the U.S. FASB requires firms to report fair value decrements of investment properties in financial statements through impairment charges to avoid overstating assets, but forbids firms to report fair value increments. That is, fair values of investment properties are estimated by managers,

and this reduces their faithful representation. Yet, if U.S. listed firms adopt IFRS in the foreseeable future, they will presumably report fair value increments for investment properties in financial statements.

The third analysis provides evidence that fair values of investment properties reported in a real estate firm's financial statements on average are sufficiently faithfully represented and are thus more value relevant to investors than historical cost income. Yet, the findings suggest that around the severe real estate crisis of 2007–2009, unrealized losses—primarily reported around 2007–2009—are not more useful in explaining market fluctuations than historical cost income that includes impairments. Because in good times book values of investment properties are adjusted upward under the fair value model, the findings might imply that managers are reluctant to report large unrealized losses in bad times, decreasing the value relevance of unrealized losses over impairments. This might compensate for the fact that, in contrast to impairments, unrealized losses are likely reported immediately with the economic downward trend of the investment properties in a real estate firm's financial statements, and estimated in a routine fashion. Overall, the findings suggest that the fair value model for investment properties is capable of being more useful to investors than historical cost income. More research, however, is needed in this area. In particular, it would be interesting to examine the argument that managers are reluctant to report large amounts of fair value decrements in financial statements and whether unrealized losses are faithfully represented outside of crises.