Research Assessment Exercise 2020
Impact Case Study

University: The Hong Kong Polytechnic University
Unit of Assessment (UoA): Accountancy (UoA20)

Title of case study: Accounting for Fair Value of Assets: Panacea or Pandora's Box?

(1) Summary of the impact

Fair value accounting is an extremely important issue for regulators and practitioners because it involves two fundamental accounting concepts: relevance and reliability. In particular, there have been significant concerns about how fair value accounting would affect firm valuation and contracting. Prof. Jeffrey Ng and Dr Yong Zhang have published both academic and practitioner articles on fair value accounting in order to promote understanding and offer solutions. During their studies, they have interacted with various stakeholders, conducted surveys to solicit feedback and spoken at public forums. Their work has been central to valuable knowledge transfer and policy-making.

(2) Underpinning research

The research underpinning this impact case study is concerned with the topic of fair value accounting. Recently, accounting standards have shifted towards a stronger use of fair values. This resulted in a divergence of opinions about the impact that this shift has on practice. Proponents argue that fair value accounting enhances the relevance, whereas opponents argue that it diminishes the reliability of financial reports.

Prof. Ng has published an industry report **[R1]** (funded by a government grant) to conduct practitioner-based research on trust in fair values. In brief, the lack of trust in fair value numbers exists largely because of concerns about the numbers' reliability, especially for assets without readily available prices. The issue of trust is important for accounting because accounting's value lies in the faith one has in the disclosed numbers. Hence, to develop a better understanding of how various stakeholders view the production, delivery, and processing of fair values, Prof. Ng applied for the role of principal investigator in order to study this issue from the perspective of practice. Outputs include an industry report **[R1]** and the public presentation of Prof. Ng's research at an industry convention. This industry report can be viewed as an extension of the academic research paper, **[R2]**, in which Prof. Ng investigates how investors price the fair value estimates of assets as required by Statement No. 157 of Financial Accounting Standards, which was created after the financial crisis in 2008. In **[R2]**, he observes that between 2008 and 2011, Level 3 fair value estimates were typically priced lower than Level 1 and Level 2 fair value estimates. However, the difference in pricing between the different estimates declines over time, suggesting that as market conditions stabilized in the aftermath of the 2008 financial crisis, reliability concerns about Level 3 estimates dissipated to some extent.

In **[R3]**, Prof. Ng extends **[R1]** and **[R2]** to study firms' voluntary disclosures about the controls and processes in place to ensure the reliability of fair value estimates. Consistent with the fact that disclosures are driven by investors' concerns about reliability, he finds that firms with more opaque estimates are more likely to disclose. He also finds that disclosure is associated with higher market pricing and lower information risk for Level 3 estimates. A key policy implication of **[R3]** is that regulators should consider mandating or encouraging firms to increase the transparency of the reported fair value numbers via more disclosures.

Dr Zhang published two papers, **[R4]** and **[R5]**, that highlight managerial opportunism under fair value accounting. **[R4]** investigates the impact of CEO compensation structure on post-acquisition purchase price allocation, which is an accounting procedure that involves the fair value estimation of various assets and liabilities. He finds that CEOs whose compensation packages rely more on earnings-based bonuses are more likely to over-allocate the purchase price to goodwill—the largest asset recorded after an acquisition. Because goodwill is not amortized, the overallocation likely increases post-acquisition earnings and bonuses.

Building on **[R4]**, **[R5]** studies the initial valuation of goodwill and identifiable intangible assets after an acquisition. Dr Zhang's findings suggest that unverifiable fair value measures are associated with the underlying economics, but that they deviate from true values in the presence of management reporting incentives. Further analysis suggests that external appraisers constrain managerial discretion over intangible asset valuation to some extent, but they do not completely eliminate it.

(3) References to the research

[R1] "In fair value we trust, or not", co-authored with Chu Yeong Lim, Kevin Ow Yong, and Gary Pan. (2017). Industry report published by Institute of Singapore Chartered Accountants in conjunction with the Singapore Accountancy Convention. Funded by Singapore Ministry of Education Academic Research Fund Tier 2 Grant, entitled "The production, delivery, and processing of fair values".

[R2] "Market pricing of banks' fair value assets reported under SFAS 157 since the 2008 financial crisis", co-authored with Beng Wee Goh, Dan Li, and Kevin Ow Yong. *Journal of Accounting and Public Policy*, 34 (2), (2015), 129-145.

[R3] "Voluntary fair value disclosures beyond SFAS 157 three-level estimates", co-authored with Sung Gon Chung, Beng Wee Goh, and Kevin Ow Yong. *Review of Accounting Studies*, 22 (1), (2017), 430-468.

[R4] "CEO compensation and fair value accounting: Evidence from purchase price allocation", co-authored with Ron Shalev and Ivy Zhang. *Journal of Accounting Research* 51 (4), (2013), 819-854.

[R5] "Accounting discretion and purchase price allocation after acquisitions", co-authored with Ivy Zhang. *Journal of Accounting, Auditing, and Finance* 32, (2017), 241-270.

(4) Details of the impact

Prof. Ng is very active in producing impact via collaboration with the standard setters and industry partners. To increase the impact of his research beyond academia, Prof Ng, as the principal investigator, obtained a large grant from the government to conduct practitioner-based research. Specifically, he and his research team worked on a survey together with two organizations: the Institute of Singapore Chartered Accountants (ISCA) and the Institute of Valuers and Appraisers of Singapore (IVAS) **[S1]**. ISCA is Singapore's national accountancy body. Its goal is to be a globally recognised professional accountancy body, bringing value to its members, the profession, and the wider community. IVAS has been established under the umbrella of the Singapore Accountancy Commission and is now a member of the International Valuation Standards Council. It seeks to foster professional excellence in the area of business valuation through the development of competency frameworks, the promotion of professional valuation standards and other related activities. An important benefit of the collaboration between academics, regulators, and practitioners is the interaction between academics and practitioners, which helps to develop a more holistic mutual understanding of the various issues surrounding fair value accounting.

PolyU, together with the Institute of Singapore Chartered Accountants, the Institute of Valuers and Appraisers of Singapore, the Singapore Institute of Technology, and Singapore

Management University, were indicated as the organizations involved in conducting the survey and in generating the various outputs related to it. The survey results were also published in an industry report **[R1]**, which was widely disseminated to the members of the abovementioned professional bodies. The report shares valuable insights into how survey participants view the conceptual framework underpinning financial reporting and how fair value accounting fits in this framework to create trust in financial reporting. Highlights from the report are also included in a presentation entitled "Trust in Fair Value Accounting" **[S2]** at the Singapore Accountancy Convention held on August 25, 2016 **[S3]**. The convention was co-organized by ISCA and the Accounting and Corporate Regulatory Authority (ACRA), with attendance by government ministers, regulators, researchers, and practitioners. ACRA is the national regulator of business entities, public accountants and corporate service providers in Singapore.
Prof. Ng's academic papers have impact on policy-making. To illustrate this point, some excerpts from an email from Rebecca Villmann, who is a director at Financial Reporting and Assurance Standards Canada **[S4]**, are provided below:

i) "Professor Ng's and colleagues' research has already had an impact in standard setting. After a new standard has been applied for several years, many standard setters undertake post-implementation reviews to assess if the resulting changes from the standard were effective and can learn of unexpected application issues (e.g. not more complex to apply than intended). I see that R1, possibly R2 (if renamed to "Trust in Fair Value Accounting: Evidence from the Field" (same authors) and R3 were cited in a literature review that was commissioned by the IASB. These findings along with stakeholder feedback were considered by the IASB. They issued a feedback statement of their review."
ii) "I personally find value in research that demonstrates the relevance of transparent disclosures about higher risk items or about difficult judgments as valuable, especially when a positive market effect is identified. Such findings not only can help standard setters in requiring more disclosures as well as encouraging management to comply and provide transparent disclosures. It is important that such messages are shared with practitioners, for example through an article."

As for other examples of his research impact, **the Institute of Chartered Accountants of India's press monitoring service provides an online index of articles which are viewed as useful and important, and selected to be introduced to its members. In 2015, this index listed [R2] in its central council library [S5]. Similarly, [R3] was disseminated via an executive summary [S6] by the International Association for Accounting Education and Research, which is an organization sponsored by KPMG and the Association of Chartered Certified Accountants.**

Dr Zhang's work has contributed to policy-making and to guiding practitioners on the application of accounting standards. IASB (International Accounting Standards Board) is the authority responsible for setting the accounting standards adopted by more than 40 countries, including most European Union countries, Japan, China, and Hong Kong. IASB prepares agenda papers for the purpose of setting these standards out. IASB Agenda Paper 12A (December 2014) **[S7]** refers to a working paper version of **[R4]** in the following way: "Shalev et al. (2011) found that allocation of purchase price to goodwill was higher when managerial compensation included larger cash bonuses. They concluded that non-amortisation of goodwill provides an incentive for managers to record higher amounts for goodwill thus avoiding amortisation and impairment on definite life intangible assets" (page 8). Page 24 of the same document refers to Shalev et al. (2011) as showing that "Allocation of purchase price to goodwill is higher when there are larger bonuses in CEO packages". **[R4]** has also been featured in the Harvard Law School Forum on Corporate Governance and Financial Regulation, which is a blog serving as a forum for the exchange of ideas and debate among lawyers, executives, institutional investors, academics, and regulators **[S8]**.

The findings in **[R5]** were discussed on page 414 of *Applying IFRS Standards* **[S9]**, a book that explains the core principles of IFRS and addresses the skills needed to apply the standards in business environments: "Shalev et al. (2013) study how managerial compensation affects this price allocation. They examine 320 acquisitions between 2001 and 2008 and test for the association between a CEO's cash bonus (which is typically based on accounting numbers) and the percentage of the purchase price that is allocated to goodwill and intangibles with an indefinite life. Shalev et al. (2013) provide evidence that suggests that greater bonus intensity is positively associated with the percentage of purchase price that is allocated to goodwill and intangibles with indefinite life. This is consistent with managers of acquiring firms using discretion to allocate a greater fraction of the purchase price to assets that are not subject to depreciation and amortization which, in turn, boosts future profits."

Finally, Prof. Ng and Dr Zhang have worked together to create an impact on accounting practice. In a joint impact case study presentation entitled "Fair Value Accounting" **[S10]**, they shared their findings in **[R1-R5]** at the *China Accounting and Finance Review* Knowledge Transfer Forum held in Hong Kong and Dongguan on September 20 and 21, 2019, respectively. The objective of this forum was to provide a platform for academics and practitioners to engage in an exchange of ideas that create impact for industry and society. Impact case studies and practice-based theses were presented, followed by a corporate visit to Huawei in Shenzhen. This event attracted more than a hundred participants, including Mr Andrew Fung, CFO of Henderson Land Development Company Ltd, and Dr Ricky Szeto, General Manager and Executive Director of Hung Fook Tong Group Holdings Ltd. A survey conducted after the forum indicates that the participants are satisfied with what they have learnt through the forum.

(5) Sources to corroborate the impact

[S1] "Fair Value Survey". An online survey produced and conducted in collaboration with two organizations: the Institute of Singapore Chartered Accountants (ISCA) and the Institute of Valuers and Appraisers of Singapore (IVAS).

[S2] "Trust in Fair Value Accounting". PowerPoint slides used in a presentation at the Singapore Accountancy Convention held on August 25, 2016.

[S3] Singapore Accountancy Convention 2016 website. https://isca.org.sg/cpe-events/calendar/events-calendar/2016/august/singapore-accountancy-convention-2016/

[S4] Email entitled "Impact of Research" from Rebecca Villmann on September 4, 2019.

[S5] The Institute of Chartered Accountants of India Press Monitoring Service https://www.icai.org/post.html?post_id=11827

[S6] "Bank Disclosure Quality and the Subprime Crisis - Fair Value Disclosures Beyond SFAS 157". Executive summary by International Association for Accounting Education and Research. https://www.iaaer.org/attachment/163/download/SFAS157_Executive_Summary_IAAER

[S7] International Accounting Standards Board (IASB) Agenda Paper 12A (December 2014) https://www.ifrs.org/-/media/feature/meetings/2014/december/iasb/ifrs-ic-issues/ap12a-discussion-of-constituent-feedback-and-academic-research.pdf

[S8] "CEO Compensation and Fair Value Accounting". Harvard Law School Forum on Corporate Governance and Financial Regulation. https://corpgov.law.harvard.edu/2013/07/12/ceo-compensation-and-fair-value-accounting/

[S9] Picker, R., Clark, K., Dunn, J., Kolitz, D., Livne, G., Loftus, J., & van der Tas, L. (2019). *Applying IFRS Standards*. 4th edition. Chichester, West Sussex, United Kingdom: John Wiley & Sons.

[S10] China Accounting and Finance Review Knowledge Transfer Forum. Impact case study presentation "Fair Value Accounting". YouTube video clip: https://www.youtube.com/watch?v=FtWIMcXdPMs&feature=youtu.be