An Analytical Study for the Relationship between Fair Value Accounting and Earning Management

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Introduction

The use of Fair Value in financial reporting has developed a debate about the impact of fair value accounting on Earning Quality. FVA is a market-based measurement. Nevertheless, Fair Value is considered unreliable and often it is subject to managerial discretion, especially when markets are illiquid or inactive. Fair value is based on subjectivity in estimation that allows management opportunities for the exercise of judgments and intentional bias as a result the quality of financial reporting decrease and negatively affects stakeholders' decisions. Management discretion can result in a higher earning quality and in a reduced amount of earning quality.

Key words: fair value accounting, earning quality, earning management.

This paper is classified through the following sections

Section One: Fair Value Accounting and Financial Reporting.

Section Two: Earnings Quality and Earning Management.

Section Three: The Relationship between Fair Value Accounting and Earning Management.

Section One: Fair Value Accounting and Financial Reporting

The use of Fair Value in financial reporting has sparked the debate about the qualities of an FVA-based reporting system (Menicucci, 2019). The fair value in financial reporting provides more transparent and reliable financial information than the historical cost (Dietrich et al. 2000; Danbolt and Rees 2008). In 2011, as an effort to facilitate more accurate financial reporting a joint project between International Accounting Standard Board (IASB) and Financial Accounting Standard Board (FASB) issued International Financial Reporting Standard 13 (IFRS 13). In order to provide a single framework for measuring fair value and enhance disclosure regarded fair value estimates. IFRS 13 defined fair value as "the price that would be received to sell assets or paid to transfer liabilities in an orderly transaction between market participants at the measurement date".

When markets are liquid, Fair Values are reliable measures of assets and liabilities since the estimates represent the present value of expected future cash flows. In this case, Fair Value measurements at Level 1 and Level 2 reflect the volatility of the active market and provide greater value relevance to financial statements' users than the Level 3 valuations. Conversely, when markets are illiquid or inactive, Fair Value estimates are potentially unreliable due to the absence of quoted market prices and the inherent error in either the measurement technique or the inputs of it (Level 3 valuations). Level 3 fair values are based on

models and managements assumptions. Therefore, they can be manipulated easily by managers.

Section Two: Earnings Quality and Earning Management

The last decade has witnessed several accounting scandals, mainly because of the manipulation of the accounting figures provided in the financial statements (Goncharov, 2005). Moreover, financial statements are a major communication device between companies and investors. The capital market requires unobvious financial reporting processes to improve the confidence of investors (Jaffar et al., 2007). Earning fundamentally is an alternative way to sound the profit of the company. Earning quality (EQ) is lately becoming of considerable interest to participants in the financial reporting process. Hence, Menicucci (2019) defined earnings quality as "an important aspect of evaluating an entity's financial health and it is a significant summary characteristic of accounting systems". Additionally, earnings are described as being of high quality when they accurately reflect current performance, they indicate future performance and they are a useful summary for assessing firm value. EQ refers to the ability of reported earnings to reflect the company's true earnings.

Moreover, earnings management is an act of manipulating earnings. Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to

alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Alzoubi, 2018). Earning management as an action used to gain profit and this action tends to be part of the management's personal interests. The purpose of earnings management is to demonstrate reasonable earnings quality that meets either the shareholders' expectations, or the requirement of obtaining relevant authorization from regulators (Ahmadpour and Shahsavari, 2016). Despite the importance of earnings management, earnings quality is necessary to better understand the situation of the company and financial decisions.

Section Three: The Relationship between Fair Value Accounting and Earning Management

Over the years, the concerns related to the reliability of fair value seem to be connected to the observability of the inputs and more generally to the degree of transparency in the valuation process (Pompili and Tutino, 2019). Hence, the use of unobservable inputs that could allow opportunistic behavior by the management through providing biased estimates of fair value with the aim of achieving their own goals. Additionally, earning management is a plan of an entity intentionally manipulates or modifies it with the idea of raising and lowering the company's earning so that it fits the company's target (Iraya et al., 2015). This definition shows the existence of earning management,

financial reports do not describe the actual condition of the company.

An intensive use of unobservable inputs could lead to biased values estimation and so to earning management practice (Benston, 2008). Moreover, lower quality of accounting information to stakeholders is reflected on the efficiency of the decision process in investment allocation and leads to information asymmetries problems (Ball et al., 2012; Siekkinen, 2016). Fair value accounting specifically the unobservable inputs of Level 3 could bring to an increase of information asymmetries that generally has a positive correlation with earning management (King, 2008).

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