

Factors Influencing CFOs of US-based Companies towards Adoption of the Fair Value Accounting Option and International Financial Reporting Standards

Abstract: This paper reports how and why CFOs of public companies in the United States react to the choice of International Financial Reporting Standards (IFRSs). As hypothesized in the paper, we found that CFOs of “Larger” firms with lower “Return-on-Equity,” and higher “Debt-to-Equity” ratios are more likely to be positive about the option to use IFRS for their U.S. filings. Furthermore, this study reports how and why CFOs react to the choice of the fair value option for non-financial assets and long-term liabilities based on FAS 157 and FAS 159. As expected, we found CFOs of firms with lower “Return-on-Equity” and proportionally larger amounts of “non-monetary assets and long-term liabilities subject to Level 2 and Level 3 FAS 157 fair value measurement,” are more resistant to choosing the fair value option. Opposite to our expectations, however, CFOs’ responses indicated that they do not support/reject the fair value measurement based on the “adverse influence on debt or bonus contracts.” Our statistical results also show that CFOs’ responses to the fair value measurement choice is not dependent on “Debt-to-Equity” ratio, as it is marginally significant and in the opposite-to-expected direction. Additional sensitivity analysis did not reveal any new information or show that the respondents, when controlled for industry and firm size, were significantly different from non-respondents with respect to variables included in this study.

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I. INTRODUCTION

This paper investigates the effect of firms' characteristics on their CFO's choice of the fair value option as provided by FAS 159. In another paper, Daniel et al. (2009) provide information on how 208 CFOs responded to whether they would choose the fair value option; however, Daniel et al. (2009) did not discuss possible theoretical reasons for the CFOs' choice. In this paper, we have theorized and found relationships between some of the firms' characteristics and CFOs' responses to the choice of fair value measurement before the choice became available. Using 10-Qs of sample firms, we have, furthermore, been able to link the responses to the possible difficulty (hence costs) associated with the fair value measurement. To our knowledge, this is the first empirical research that seeks responses from preparers of the financial reports regarding the fair value accounting option. Most other studies have used data from financial statements to test the usefulness of the fair value measurement option based on other market measures (such as stock market reaction). This paper also discusses CFOs opinions related to the choice of International Financial Reporting Standards (IFRS) for U.S. filings.

In 2005 the European Commission required all companies listed in the European Union to prepare financial statements according to IFRS.¹ As global capital markets develop, more companies choose to be cross-listed in multiple stock exchanges. Because recent movements by the SEC and the Financial Accounting Standards Board (FASB) indicate that IFRS may become U.S. GAAP, public accounting firms are now assisting companies (preparers) in planning for reporting financial statements according to IFRS. The websites of all larger accounting firms have information about IFRS and the differences in measurement and disclosures between U.S.

¹ Most of this background has been adopted from Daniel et al. (2009).

GAAP and IFRS. Some firms have also supported research related to this topic. For example, a Deloitte (2008) study focuses on the preparers' level of understanding and awareness with regards to the fair value accounting option in IFRS. Accounting firms realize that it is extremely important that preparers (CFOs) not only be aware of differences between U.S. GAAP and IFRS, but be prepared to report their financial statements based on IFRS.

Beginning in March 2008, the SEC has allowed multi-national corporations (MNCs) not based in the U.S. to file financial statements prepared according to the English version of IFRS (SEC 2007a) without reconciliation to U.S. GAAP.² Many in the U.S. did not support this action³, with their main opposition centering on the fact that U.S. GAAP and the IFRS were different in many of their measurement and disclosure requirements.

The FASB and the International Accounting Standards Board (IASB) have addressed many accounting differences and continue to do so. They are currently working to adopt a similar framework to facilitate future joint, standard-setting projects. One of the main differences between U.S. GAAP and IFRS is the availability of alternative measurement choices (historical cost and fair value) for non-financial assets and liabilities. U.S. GAAP required historical cost measurement in many cases, while IFRS allowed both historical cost and fair value. In a move towards encouraging the adoption of fair value methods in the U.S., the FASB issued two standards: FAS 157 (2006), *Fair Value Measurements*, and FAS 159 (2007), *The Fair Value Option for Financial Assets and Financial Liabilities*. FAS 157 provides a common definition for fair value while FAS 159 expands the applicability of the fair value option.⁴

² In August 2007, the SEC issued a concept release stating it was considering allowing US-based companies to choose whether to file financial statements according to U.S. GAAP or IFRS (Securities and Exchange Commission 2007b). To date, the SEC has not issued any other statements following up this concept release.

³ One can inspect the SEC's website to see many of the comments received by the SEC opposing the rule.

⁴ SFAS 157 and 159 did not require the use of fair value for all assets and liabilities, but extended the option of using fair value as GAAP for some that did not exist before.

Although the FASB postponed adoption of these two Statements for one year, the postponement period has now expired and both Statements represent U.S. GAAP.⁵ The first results for implementation of these Statements are now reflected in the quarterly reports of U.S. public firms and this study will provide insights from its influence on the sample of firms in the study. Our findings provide evidence that firms with lower Return-on-Equity and higher Debt-to-Equity ratios are more likely to prefer having the option to use IFRS for their U.S. filings. Also, we found that this effect is marginally higher (at the 0.10 level) for larger firms.

With regards to choice of fair value measurement for assets and liabilities, our results indicate that those firms with lower (higher) Return on Investment, lower (higher) Debt-to-Equity ratios, and lower (higher) amounts of assets and liabilities that are subject to Level 2 and Level 3 measurement (as defined by FAS 157), prefer to choose (not to adopt) the fair value option. While these results, except for the one related to the Debt-to-Equity ratio, are consistent with our predictions, given that the number of those who wanted to adopt fair value is approximately 9% of our total sample, we caution about their generalizability.

This paper is organized as follows. Section II provides our review of literature followed by our hypotheses development (section III). Section IV discusses how we selected our sample. Section V reports the results of this study, followed by the summary and concluding remarks in Section VI.

II. Literature Review

⁵ Companies with fiscal years beginning after November 15, 2007 are required to adopt FAS 157. However, FASB Staff Position, No. 157-2, partially delays the effective date of FASB Statement No. 157 for non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). The delay is intended to allow the Board and constituents additional time to consider the effect of various implementation issues that have arisen, or that may arise, from the application of Statement 157. Early adoption is possible.

Perhaps the first real attempt in the U.S. to implement fair value measurements was when some U.S. public firms were required to disclose non-audited supplemental financial statement information using replacement cost and general price level adjusted amounts during the high inflation years of the late 1970's. While this requirement was dropped after inflation was brought under control, the debate about the shortcomings of historical-cost-based financials has not subsided. Herrmann et al. (2006), in a review of the history of the sentiment towards these antipodal accounting methods, concludes that many consider fair value accounting to be so significant that it represents a paradigm-shift in accounting. From such statements, one can easily understand why the debate on fair value accounting measurement continues to be necessary.

This debate has become more important in recent years as the assets of financial institutions have devaluated and reporting them at fair market values has resulted in regulatory intervention and/or bankruptcy proceedings. Some have blamed the current financial crisis on fair value accounting and the reporting of the reduction in value of (financial) assets. In October 2008, the U.S. Congress responded to the financial crisis, and Section 132 of the Emergency Economic Stabilization Act of 2008, titled "Authority to Suspend Mark-to-Market Accounting" reaffirmed the SEC's authority to suspend the application of fair value measurement if the SEC determines that it is in the public interest and protects investors. Furthermore, the Act required the SEC to conduct a study on mark-to-market accounting standards as provided in FAS 157. The result of the SEC study suggested that existing fair value and mark-to-market requirements should not be suspended.

While the SEC was being pressured in October 2008, the IASB was also under political pressure to adjust its mark-to-market rules. Sir Tweedie, the chairman of the IASB, was afraid

that the European Commission would set new legislation that might weaken (or eliminate) the IASB. Fearing such political consequences, the IASB changed portions of its mark-to-market rules in only four days without going through its required due-process.⁶ Obviously, this action damaged the independent status of the IASB, and this Board is now considering finding supporters (similar to what the SEC is for FASB) to defend the IASB during political situations.

To clarify its position, the FASB has issued different Staff position papers, but these have also been the subject of criticism. Both the American Institute of Certified Public Accountants (AICPA) and the Center for Audit Quality (CAQ) criticized FAS 157-e, *Determining Whether a Market is Not Active and a Transaction is Not Distressed*, (Staff Position 157-e, 2009).⁷ As a result, the FASB made a significant adjustment to the proposed Staff Position and issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, on April 9, 2009.⁸

In general, fair market accounting is expected to provide fundamental and relevant values for assets and liabilities. But when the economy suffers from a significant recession or experiences a bubble, these values may result in misleading numbers (Leonard 2008). Similarly, when the price discovery process is not present (i.e. no market exists), perhaps because of a meltdown, then mark-to-market may not result in accurate valuations. Consequently, an important criticism of fair value measurements is the existence of an inactive market for an

⁶ Some of the results of this change were dramatic. For example, Deutsche Bank turned a \$970 million quarterly pretax loss into a \$120 million profit. Also see, <http://www.iasb.org/About+Us/About+Advisory+Groups/About+the+Financial+Crisis+Advisory+Group.htm> and <http://www.nysccpa.org/blog/2009/1/6/tweedie-iasb-yielded-political-pressures> for more detailed coverage.

⁷ FASB Staff Position (FSP) FAS 157-e, 2009 “Determining Whether a Market Is Not Active and a Transaction Is Not Distressed.”

⁸ This FSP shall be effective for interim and annual reporting periods ending after June 15, 2009, and shall be applied prospectively. Early adoption is permitted for periods ending after March 15, 2009.

asset/liability (hence the difficulty of measurement) and the resulting fluctuation in balance sheets and income statements. Although it supported the fair value measurement, PriceWaterhouseCoopers (PwC) (2008b) reflects on the issue of fair value measurement from three aspects: the relevance of information to investors, the reliability of that information, and companies' ability to measure the assets/liabilities.

FAS 157 established a three-level hierarchy to help clarify how to measure fair value. Level 1 inputs have active markets with quoted prices for identical assets or liabilities. Level 2 inputs have reasonably available prices and include quoted prices in markets for comparable assets and liabilities. Level 2 inputs are more costly to obtain than Level 1 inputs. Level 3 inputs are unobservable, hence the most difficult and costly to measure. If we accept that fair value is relevant in all its measurement bases, companies have the most difficulty measuring Level 3 and Level 3; hence Level 3 and Level 2 information is less reliable.

When the option of fair value is available,⁹ most studies indicate that companies do not use the option. For example, Demaria and Dufour (2007) found that the number of firms that clearly adopted fair value for each specific item ranged from 0 to 19 of the 120 most actively traded stocks listed in Paris as reflected in Société des Bourses Françaises-SBF- 120. They found that the most significant predictor for adopting fair value was membership in the financial services industry. Furthermore, the choice was unrelated to size, financial leverage, CEO's compensation, institutional ownership, and cross-listing. They suggest that French companies prefer the conservative method of reporting their assets and that contracting theory, see-through-accounting-methods/numbers hypotheses, resistance to change, the complexity of the fair value

⁹ Since the option for the fair value measurement and reporting is rather recent for U.S. companies, most of our review of literature has concentrated on studies that are related to IFRS fair value requirements/options. Among them are studies based on the European Union's adoption of IFRS in 2005.

option, and uncertainty resulting from using fair value accounting all contributed to lack of interest in its adoption.

Cairns et al. (2008) also saw lack of interest in fair value in their investigation of the use of fair value measurement by 195 companies listed in the U.K. and Australia following the adoption of IFRS in January 2005. Their results show very little voluntary use of fair value measurement for tangible, intangible, or financial assets, and they suggest that most companies in the U.K. and Australia prefer a conservative approach and/or lack incentives to use fair value measurement. In a more recent study of 1,539 companies (934 in the UK and 605 in Germany), Christensen and Nikolaev (2008) found that options in IFRS did not provide additional incentives for German and U.K. firms to switch to fair value accounting. In fact, they were surprised to find that companies in the U.K. that have traditionally used fair value for real estate, upon the adoption of IFRS, elected to switch to historical cost. Overall, Christensen and Nikolaev find that companies generally perceive that the benefits of fair value do not exceed its costs.

Hitz (2007) suggests that fair value valuation is relevant both from the measurement perspective and from the information perspective. As such, investors may find fair value information more useful than historical cost information and in response, managers of U.S. companies may adopt fair value measurement and reporting if their competition chooses to do so. Since foreign companies following IFRS have had the fair value option, managers of U.S. firms may choose to adopt fair-market valuation in lieu of historical costs to make sure that they remain competitive. Analyzing Form 20-Fs, Daniel et al. (2009) found that 53 (6.3%) foreign-listed companies in the U.S. used fair market value as the basis for measurement and reporting PP&E, four (4) used a combination, and the rest (93.2%) used historical cost as the basis. Their

finding, similar to that of prior research, indicates that the fair value accounting option is not widely used by foreign companies. It, however, indicates that some foreign companies listed in the U.S. used fair value measurement and reporting while their U.S. counterparts did not have this option. While we believe that U.S. companies may choose the fair value option because of their competition, we do expect to find a lack of interest in the use of fair value valuation for non-monetary assets/liabilities.

Some value relevance studies have addressed the usefulness of fair value measurement. Song et al. (2008) summarizes such studies. Most studies that concentrate on U.S. companies test the value relevance when a change in U.S. GAAP results in (mandatory) release of information to the market (e.g., those related to FAS 107, *Disclosures about Fair Value of Financial Instruments*). However, as Song et al. (2008) indicate, the fair value measurements used in existing accounting literature are not necessarily consistent with FAS 157 because prior to FAS 157 there was no single fair value definition. Song et al. (2008) investigated the value relevance of early adoption of FAS 157 and found that Level 1 and Level 2 fair value measurements provide strong value relevance, while Level 3 fair value measurements are only weakly value relevant.¹⁰

Furthermore, they found that the value relevance of fair value adoption has a direct relationship with corporate governance; the weaker the corporate governance indicators, the lower the value relevance of fair value measurement. Other studies have also indicated that Level 1 fair value measurement provides value relevant information (e.g., Barth 1994; Petroni and Wahlen 1995; and Carroll et al. 2003). Since upward asset revaluations are not allowed

¹⁰ As expected, the number of early adopters was not large. The sample size in Song et al. (2008) was 59 companies (167 firm-quarter observations).

under U.S. GAAP, several studies examine the value relevance of the revaluation of fixed assets using other countries' data (e.g., Cairns et al. 2008, mentioned above).

III. Hypothesis Development

The introduction of this paper provided a background about the interest regulatory bodies (SEC, FASB, and IASB) and larger accounting firms have shown in IFRS as U.S. GAAP. Many countries, including Canada, have already adopted IFRS as their national GAAP and all indications point to IFRS becoming U.S. GAAP. A study of 130 reconciliations from (20 F) foreign filers using IFRS in 2006 showed that approximately 2/3 of the companies reported higher earnings under IFRS than under U.S. GAAP; the median difference was 12.9%, but in some cases income more than doubled under IFRS 9 (Ciesielski, 2007). Hence we can safely assume that IFRS will have more upward effect on asset and income values, and therefore managers may consider the adoption of IFRS more favorably when their Return-on-Equity is lower. We can also propose that firms with higher debt-to-equity ratios prefer IFRS to avoid possible contractual costs associated with closeness-to-debt covenants. Also, larger firms have more incentive to adopt only one set of GAAP as they are more often involved in foreign operations and subsidiaries. Having collected CFOs' responses to the choice of adopting IFRS, we are able to test the following hypotheses (stated in alternative form) with respect to the effect of the Return-on-Equity ratio, the Debt-to-Equity ratio, and the size of companies on their willingness to choose the IFRS option.

H1: Companies with a lower Debt-to-Equity ratio prefer the IFRS option (a negative relationship is expected).

H2: Companies with a higher Return-on-Equity ratio, prefer the IFRS option (a positive relationship is expected).

H3: Smaller companies prefer the IFRS option (a negative relationship is expected).

Most of the questions in Daniel et al.'s (2009) survey are related to the choice of fair value and reasons for CFOs' different attitudes/perceptions towards the fair value option for assets and liabilities. Everything else being equal, in normal economic conditions these companies would report higher values for their net assets¹¹ and better financial ratios (e.g., Debt-to-Equity ratio) using fair value. However, fair value is costlier to measure and report than historical value.

CEOs' responses/analysis may be influenced by their company's industry and size. For example, manufacturing companies may need to spend more resources for fair valuation than service companies if they report the fair value of non-financial assets. Hence, manufacturing companies may be more resistant towards using fair market valuation. Also, the cost of valuation for similar assets may be similar no matter the value at which the asset is measured (e.g., the appraisal cost of residential houses in most cases is the same no matter how much the value of the house); hence the cost may not be as material to larger companies as it is to smaller companies. Consequently, larger firms may consider the cost of the use of fair valuation differently from and lower than smaller firms when they consider the cost as a proportion of their total assets. Hence we expect smaller companies to be more reluctant to use the fair value option.

Daniel et al. (2009) have already provided evidence that different industries have different responses to IFRS and fair value options. They reported that "Resource" industries were more in favor of the IFRS choice and were more inclined to adopt fair value for non-financial assets. Similar to other studies, their results also showed that the percentage of those who would use the fair value accounting option for assets and liabilities is very small (about 9%). However, they did not provide evidence that the size of the company was related to CEOs' responses. This lack of result for size variable could be related to the researchers' lack of control for other firm-

¹¹ Assuming that historical book-value undervalues most non-monetary assets.

specific characteristics. In the current study, we have addressed this short coming and test the following hypothesis (stated in alternative):

H4: Smaller companies are more inclined to choose fair value options for non-financial assets and liabilities.

Similar to Demaria and Dufour (2007), we theorize that contracting theory (such as debt covenants), the complexity of the fair value option (hence its associated costs), see-through-accounting-methods/numbers hypotheses, resistance to change, and uncertainty resulting from using the fair value option, will contribute to how CFOs' react to the fair value choice provided in FAS 157/159. We can test our proposition for contracting theory by using the Debt-to-Equity ratio as a proxy for the effect of debt covenants. This ratio has been widely used in the literature as such a proxy. If higher Debt-to-Equity ratios are interpreted as firms' closeness to their debt covenants, we should find that firms with higher Debt-to-Equity ratios prefer the fair value option. The following hypothesis (in alternative form) states our contracting theory hypothesis:

H5: Companies with lower debt-to-equity ratio prefer fair value option for assets and liabilities (a negative relationship is expected).

If the CFO of a company believes that using the fair value option can provide a better picture of the firm (and possibly an improvement in comparison to competition and an increase in the firm's valuation), the CFO may also be inclined to choose the fair value option. We have used Return-on-Equity as a measure of how well the company has performed and predict that the lower the Return-on-Equity, the more likely the CFO will be to react favorably to the fair value option. The following hypothesis will be tested (stated in alternative form):

H6: The higher the Return-on-Equity, the more companies prefer the fair value option for assets and liabilities (a positive relationship is expected).

Given that Level 2 and Level 3 valuations for assets and liabilities are more complex and costly for companies, we can assume that they can be used as a proxy for the effect of “complexity and cost of the fair value option” on CFOs’ responses. As such the following hypothesis will be tested (stated in alternative form):

H7: The more Level 2 and Level 3 measurement is required for reporting assets and liabilities, the more companies prefer the fair value option for assets and liabilities (a positive relationship is expected).

Since information on the fair value option has not yet been fully reported, the market has not had the information to show possible reactions,¹² we are unable to test see-through-accounting-methods/numbers, and the effect of uncertainty resulting from using the fair value option hypotheses. Also it is difficult (if not impossible) to measure the effect of resistance-to-change on management’s responses to the fair value option. Finally, because of the potential impact of fair value accounting on the cost of capital, we predict that the competition’s choice to use the fair value option may have a direct influence on the CFOs’ decisions about the use of this option. However, the measurement of the cost-of-capital effect can only be performed after some companies have chosen the fair value option while others have not. A future study may test this proposition.

IV. SAMPLE

Daniel et al. (2009) designed a survey questionnaire to elicit possible reasons for adoption or rejection of IFRS and fair value accounting options. They sought responses to the following three questions related to long-term assets and liabilities: whether CFOs of U.S. firms would like to have a choice to file statements according to U.S. GAAP or IFRS; whether they prefer historical cost or fair value accounting for non-current assets and liabilities; and the

¹² Even when the information is available, it will be difficult to separate the effect of the information in a very depressed market.

reasons for their answers. Using their results, this study extends Daniel et al.'s (2009) study by theoretically linking the CFOs' responses to firm-specific characteristics using additional data from the Compustat database and information in recently publicly released 10-Qs.

The sample is limited to companies who were subject to Sarbanes-Oxley (SOX) legislation compliance –U.S. public companies with a market value greater than \$75 million. This limit provided assurance that all companies in the sample were subject to the same regulatory requirements. The questionnaire was mailed to 2,488 companies in July 2008. It was important to request CFOs' responses before FAS 157 and 159 became effective, as we intended to measure their intentions with regards to the fair value measurement before they actually needed to adopt these two Statements. A total of 209 completed surveys were received, for a response rate of approximately 9%.

Variables such as size, debt, and equity were collected from the Compustat database. 10-Qs for the first quarter in 2008 were obtained from SEC filings. Each 10-Q was searched for disclosure related to FAS 157 and 159 and the amount disclosed for assets and liabilities measured at Level 1, Level 2, and Level 3. To make sure that the sample was not biased as well as for the purpose of sensitivity tests, we created a matched sample for our respondents. We began by examining the subset of companies with the same NAICS industry category as those of the respondents and then sought to identify companies of similar sizes. If the subset of companies within the same NAICS category was too small, we increased the size of the subset by “dropping” the right-most NAICS digit and looked for matching companies in the newer, larger subset. Once we identified our matching sample, we re-computed the same accounting ratios (such as Debt-to-Equity, Return-on-Equity) and hand-collected the same information on FAS 157/159 from 10-Qs from the first quarter in 2008.

V. DISCUSSION OF THE RESULTS

To facilitate presentation, our discussion is based on the following order, related to the three research areas: On Adoption of IFRS, and On Use of Fair Value Accounting for a) Non-financial Assets, and b) Long-term Liabilities.

On Adoption of IFRS. A little over half (52%) of the respondents would like this option and 32% would not; 16% of the firms showed no preference. These results show that most U.S CFOs were receptive to having the option to adopt IFRS. We received over 40 responses to open-ended questions, mostly from those who opposed this option. Comments were related to the following issues: IFRS is not as mature as the U.S. GAAP, does not have appropriate GAAP for regulated companies, is principle-based and requires more judgment and does not allow LIFO; the costs of using IFRS exceed the benefits; and adopting IFRS would require additional costs for training, would increase the complexity for the users, and would result in less comparability. Those in favor of adopting IFRS suggested that doing so would improve comparability and uniformity and would result in global consistency that IFRS are simpler and easier to implement.

To test the first three hypotheses, those related to willingness to have the IFRS option, we ran a surveylogistics regression. Our response (dependent) variable, IFRS, was treated as a categorical variable with three possible categories: no, no-preference, and yes. Our predictors (independent variables) were Size (log of total assets) and Debt-to-Equity and Return-on-Equity ratios. The results of this regression are reported in Table 1.

INSERT TABLE 1ABOUT HERE

As Table 1indicates, we have strong and significant results rejecting the alternative hypotheses for both Debt-to-Equity (contracting) and Return-on-Equity variables (at the 0.05

level). Although our results for the Size variable is in line with our expectation, the significance of this variable can be questioned, as its significance level is 0.10 and the Wald Chi-Square test statistics include “1,” which rejects the null hypothesis, at the 0.05 level, that Size’s coefficient is zero. Our results hold even if we include only one independent variable each time or any combination of two independent variables. Consequently, we have strong evidence that the firm-specific characteristics included in this study, i.e., Debt-to-Equity (and firms’ contracting conditions to the extent that debt-to-equity can proxy it), Return-on-Equity, and the Size of the firm (to a lesser degree), influence the CFO’s reaction to the IFRS option: alternative hypotheses, 1, 2, and 3 are rejected.

On Use of Fair Value Accounting. We received many written comments with regards to fair value accounting for non-financial assets and long-term liabilities. As expected most of the comments were negative and included issues at the heart of the objectives of accounting: the relevance and usefulness of the fair value option. More than 20 comments suggested that this information would “not be useful,” “not relevant,” “not useful for the market,” “with no economic value,” and “creates confusion in the market.” We also received over 15 comments suggesting that such values would be difficult to measure, and using fair value measurements would create conflicts between and among the management, auditors, accountants, and those who help the company with the fair valuation. Ten CFOs commented that the management may abuse the fair valuation to manipulate, smooth, and create unreliable numbers. Several other comments suggested that no one is willing to take the risk of using personal judgment after the Sarbane Oxley Act, and the use of one’s judgment can be another opening to lawsuits. Of course, the cost associated with measurement and disclosure was mentioned in written comments as well

(over 12 times).¹³ In the following paragraphs, we provide specific and separate information on the use of fair value accounting for non-financial assets and for long-term liabilities.

a) On Use of Fair Value Accounting for Non-financial Assets. The percentage of those who would use fair value accounting for non-financial assets is very small (about 9%). The lack of interest is consistent with prior studies showing that few European firms adopted fair value accounting when given the option (e.g. Cairns et al. 2008). Approximately 11% of the respondents were undecided about this issue. Our response (dependent) variable, “Asset Response,” was treated as a categorical variable with three possible categories: no, undecided, and yes. Our predictors (independent variables) were Debt-to-Equity and Return-on-Equity ratios in one model and a third variable, “Level 2 and Level 3 assets and liabilities,” in the second model.

Information for “Level 2 and Level 3 assets and liabilities” was collected from inspection of firms’ 10-Qs. When the 10-Qs did not disclose this information, we assumed that the data was missing instead of assigning a zero to the variable; 73 observations were lost to missing data. We added the amount for Level 2 and Level 3 assets (and liabilities) and scaled the results by the firm’s total assets. The resulting ratios (one for assets and one for liabilities) were assumed to be a proxy for the costs of fair value measurement if the company were to choose the fair value option.¹⁴ The higher these ratios, the more cost the company would incur cost for fair value measurement.

¹³ In total we received over 60 comments with regards to the fair value option. The details of these comments are available upon request.

¹⁴ Table 2 reports our results only for the time that we included “Level 2 and Level 3 ratio for assets and liabilities” (FAS ratio) as a single variable. The results were similar when we included “Level 2 and Level 3 ratio for assets.” Inclusion of “Level 2 and Level 3 ratios for liabilities” does not show significant results, perhaps because our sample companies show more assets than liabilities that involve Level 2 and Level 3 fair-value measurements.

We included the Size (log of total assets) variable in all models. However, it was never significant and did not change our results. As such, we have not reported regressions that included the Size variable. The results of the two model regressions are shown in Table 2.

INSERT TABLE 2 ABOUT HERE

As the Table indicates, we have strong and significant results rejecting the alternative hypotheses for both Return-on-Equity and cost of fair value measurement (Level 2 and Level 3 assets and liabilities) variables (at the 0.001 level). Debt-to-Equity (contracting) variable was significant but opposite to the expected direction. The significance of this variable can be questioned, however, as its significance level is 0.10 and the Wald Chi-Square test statistics include “1,” which means that we cannot reject, at the 0.05 level, that the Debt-to-Equity coefficient is zero.

Our results hold when we include only one independent variable each time or any combination of two independent variables. Consequently, we have strong evidence that some of the firms’ characteristics, i.e., Return-on-Equity and the cost associated with fair value measurement, influence the CFO’s reaction to using the fair value option for non-financial assets; the “assets” portions of alternative hypotheses 6 and 7 are rejected. We were not able to reject the “assets” portions of hypotheses 4 and 5 as the Size variable was not significant and Debt-to-Equity has a low significance and in the opposite-to-expected direction.

b)Use of Fair Value Accounting for Long-term Liabilities. The percentage of those who would use fair value accounting for long-term liabilities, although larger than the percentage who would use it for assets, is still very small, about 10% versus 9%. Again, this finding is consistent with prior studies, which reported that when given the option, few European firms adopted fair value accounting.

Our response (dependent) variable, “Liab. Response,” was treated as a categorical variable with three possible categories: no, undecided, and yes; however there were no observations for “undecided.” Our predictors (independent variables) were Debt-to-Equity and Return-on-Equity ratios in one model and a third variable, “Level 2 and Level 3 assets and liabilities,” in the second model. We included the Size (log of total assets) variable in all regressions. However, it was never significant and did not change our results. Therefore, we have not reported regressions that included the Size variable. The results of two regressions are presented in Table 3.

INSERT TABLE 3 ABOUT HERE

As Table 3 indicates, we have strong and significant results rejecting the alternative hypotheses related to Return-on-Equity. The “Level 2 and Level 3 ratio for assets and liabilities” (hereafter FAS ratio) variable was significant but opposite to the expected direction. The significance of this variable can be questioned, however, as it is significant only at the 0.10 level and the Wald Chi-Square test statistics include “1,” which rejects the hypothesis that this variable’s coefficient is not equal to zero at 0.05 level. To find the reason for the lack of significant results in the expected direction, we looked at the amounts disclosed in the 10-Qs for Level 2 and Level 3 liabilities. The number of firms reporting these values is approximately 1/3 of the number reporting Level 2 and Level 3 assets, and the amounts reported for liabilities are lower than those for assets. The fewer Level 2 and Level 3 measurements required for liabilities can easily explain why FAS 157 and 159 have less influence on CFOs’ responses for liabilities, as noticed in Table 3.¹⁵

¹⁵ When we included the “Level 2 and Level 3 ratio” for liabilities instead of the total “FAS ratio,” we found no significant results for the “Level 2 and Level 3 ratio” variable. This finding supports our proposition that FAS 157 and 159 have more influence on assets measurement than on liabilities measurement.

Table 3 shows that Debt-to-Equity (contracting) had a significant effect on CFOs' choice but again in the opposite-to-expected direction. This result is similar to that in Table 2, with the difference that the Wald Chi-Square test statistics do not include "1," signaling the Debt-to-Equity as an important and significant predictor (independent) variable. Our findings show that CFOs believe that using fair value for assets and liabilities will adversely affect their contracts.¹⁶ While this was not our expectation, in the survey questionnaire many CFOs did not consider "Fair Value will adversely influence our debt or bonus contracts" as one of the important reasons for their lack of interest in fair value options for assets and liabilities. As such, our results are in line with what CFOs had already indicated in their survey responses, giving some credence to the competing hypotheses with regards to Debt-to-Equity ratios.

Overall, we have strong evidence that some of the firms' characteristics, i.e., Return-on-Equity and Debt-to-Equity, influence the CFOs' reaction to the fair value option for long-term liabilities. While we have support for rejecting the liabilities portion of hypothesis 6, we cannot reject that portion of hypothesis 5, hence providing an alternative explanation. We were not able to reject the liabilities portions of hypotheses 4 and 7, as the Size variable was not significant and the "FAS ratio" has a low significance and in the opposite-to-expected direction.

Additional Analysis. Our survey questionnaire allowed the CFOs to include the reasons for their support or lack of support for fair value measurement and to rank their reasons on a five-point Likert scale, with 1 being the most important and five being the least important. To find out whether a relationship existed between the ranking given by CFOs to each reason and their firms' characteristics, we ran an "ordered logistics regression" using the rank assigned to

¹⁶ The choice of "no" for fair value assets and liabilities is not significantly concentrated in any particular industry.

each question as the response variable.¹⁷ We included Size, Return-on-Equity, Debt-to-Equity and the “FAS ratio” as predictor (independent) variables. When the sample size was small, we tested our model by including only one predictor variable each time and when the sample was large enough, we ran the regression for both individual and combinations of predictor variables. We were unable to find observable and significant patterns that linked the CFOs’ assigned rankings to our predictor variables. Only in four of fifteen reasons for rejecting the fair value option for assets and liabilities (two for assets and two for liabilities), did Return-on-Equity show some significant explanatory power. Consequently, using the firms’ characteristics, we were unable to explain the weight (ranking) assigned to reasons for rejecting or supporting fair value measurement.

To have a better sense of the comparisons among the reasons, we computed a single score for each reason by assigning linearly descending weights to the responses as follows: five points for the most important reason, four points for the second-most important, three points for the third-most important, two points for the fourth-most important, and one point for the least important. Table 4 and Table 5 report the results.

INSERT TABLES 4 AND 5 ABOUT HERE

As can easily be observed, the results reported in these two Tables are in line with all of our propositions except for one: the influence of fair value on debt or bonus contracts. The CFOs prefer fair value because it provides a better picture of the firm, as was supported by the Return-on-Equity hypothesis (Tables 2 and 3) and ranked it number one in their “yes” responses in Tables 4 and 5. They do not support fair value because of the costs, as reported in the results of “FAS ratio” (Tables 2 and 3) and ranked it number one in their “no” responses in Tables 4 and 5.

¹⁷ We used a different format for the ordered values. For example, we assigned “1” to rankings of 1 and 2 and “0” to rankings of 4 and 5 in one set of analyses and “1” to rankings of 1, 2, and 3 and “0” to rankings of 4 and 5 in another set of analyses and so on. Our results did not change materially.

In the case of the influence of fair value accounting on debt or bonus contracts, the CFOs responses indicate that they do not believe that it is a significant issue; it is ranked last in Tables 4 and 5. The results in Table 2 are similar. It is obvious that most CFOs do not believe that the use of fair value measurement is detrimental to debt contracts, as we suggested in our hypothesis.

Sensitivity analysis. Like other studies that use survey questionnaires, our results may be questioned as being biased towards a set of respondents whose characteristics are different from those who did not respond. As mentioned earlier, we selected a matching sample based on the firm's NAICS industry and company size. When necessary, we dropped the right-most NAICS digit and looked for matching companies. Once we identified our matching sample, we computed the same accounting ratios (such as Debt-to-Equity, Return-on-Equity) and hand-collected the same information on FAS 157/159 from the 10-Qs of the first quarter in 2008. For matching companies that provided information for FAS 157/159, we computed the "FAS ratio." We then compared these values to those of our sample. T-test results showed that there was no significant difference between our sample and the matching sample at the 0.05 level.¹⁸ Overall, we do not have any evidence that our respondents are different from CFOs in other firms in their industries.

VI. SUMMARY AND CONCLUSION

Although many recent studies have addressed the interest in IFRS and the fair value accounting option/measurement, to our knowledge none of these studies have concentrated specifically on how and why CFOs react to the option to adopt IFRS and fair value accounting as defined and used in FAS 157 and FAS 159.

¹⁸ To satisfy our curiosity, we compared ratios of non-monetary assets to total assets as well and did not find a significant difference between the respondents and the matching sample. If we increase the minimum significant level to 0.10, the Debt-to-Equity ratios of the respondents are significantly (at 0.096) higher than those of the matching sample. This suggests that CFOs of companies with higher debt levels were more likely to respond to our survey.

We used the data collected by Daniel et al. (2009), 209¹⁹ responses from a total of 2,488 surveys, an 8.3% response rate. As Daniel et al. report, when CFOs were asked whether they wanted the option of using international financial reporting standards (IFRS), the majority of respondents indicated that they would like the option to use IFRS for their U.S. filings. Only one-third of the respondents did not want the option to use IFRS. As we expected, our test results indicated that larger firms with higher Debt-to-Equity and lower Return-on-Equity ratios prefer having the IFRS option. Some of the respondents' written comments were that IFRS are not as mature as U.S. GAAP, do not include appropriate GAAP for regulated companies, are principle-based and require more judgment, and would not allow LIFO; the costs are greater than the benefits; and adopting IFRS would require additional costs for training, would increase the complexity for the users, and would result in less comparability. Others commented that adopting IFRS would improve comparability and uniformity, that IFRS are simpler and easier to implement, and that using them would result in global consistency.

This paper also provided a background with regards to the current political atmosphere about the utilization of fair value measurements. While FAS 157 and 159 are now part of U.S. GAAP, current political pressure in the U.S. has postponed complete implementation of these statements. For example, the FASB made significant adjustment to proposed Staff Position "157-e" and issued FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*, on April 9, 2009 to be effective for interim and annual reporting periods ending after June 15, 2009. And in the international setting, the IASB changed portions of its mark-to-market rules in only four days without going through its required due-process because of its fear of political consequences. In spite of these developments, all indications suggest that the fair

¹⁹ We have included one late response and our data has one more observation than Daniel et al., 2008.

value option will continue to be available for companies in the future. However, our survey responses with regards to fair value accounting, consistent with many other studies in Europe and Australia, showed that CFOs in the U.S. were resistant to fair value measurement for non-financial assets and long-term liabilities.

This paper considered four suggestions (hypotheses) to explain CFOs' responses to the fair value option. These hypotheses examined whether CFOs' attitudes were related to firm-specific conditions such as company size, Return-on-Equity, Debt-to-Equity, and the Cost associated with fair value measurement.

When possible, we used two sources to test (or confirm) our hypotheses. First, we used data collected from COMPUSTAT and 10-Qs for the first quarter in 2008. We used Return-on-Equity, Debt-to-Equity and "Level 2 and Level 3 measurement ratio for assets and liabilities" to test hypotheses that linked Return-on-Equity (lower ROE, more positive response to adoption; negative relationship), Debt-to-Equity for debt covenants (positive relationship), avoiding Costs "Level 2 and Level 3 ratio of assets and liabilities" (negative relationship), and Size (positive relationship). The results for our Return-on-Equity and Cost variables are significant, but not the results for the Size variable. Opposite to our expectation, however, we found that the Debt-to-Equity ratio was marginally and negatively related to the choice of the fair value measurement option. Our additional analysis helped us to justify this finding.

Our second source for testing/confirming our hypotheses used the summary responses from CFOs. We asked them specifically about their reasons for choosing or rejecting the fair value measurement option. With this information, we did not need to speculate about why CFOs were supportive/resistant to fair value accounting. The main reason for their resistance was that determining the fair value was too costly. This result is similar to those from the "Cost variable"

previously mentioned and in line with our expectations. Furthermore, when CFOs selected the fair value option, they ranked “providing a better picture of the firm’s position,” as their most important reason to respond positively. This is also in line with our “Return-on-Equity” findings. Opposite to our expectation and similar to the finding reported above, they ranked the “adverse influence on debt or bonus contract” as the least important reason for resisting fair value measurement. Hence, the hypothesis that suggests that CFOs will choose/reject the fair value option in response to its effect on debt and/or bonus contract is not supported in this study. Our sensitivity analysis indicated that, when controlled for industry and size, our sample is not biased towards a specific set of conditions for the independent variables.

The full effect of FAS 157 and 159 on U.S. companies is now being reflected in financial statements (for fiscal years ending November 2008). It will be hard to measure the full effect until the data become available, but we have started to see the effects in 10-Qs and 10-Ks. An extension of this paper will be to find whether U.S. CFOs actually used this option as they suggested in this survey. When we have enough data items for statistical inference, we will test this proposition. One of our survey findings suggested that some U.S. companies may choose the fair value option for competitive reasons, to avoid an increase in their cost of capital. This topic is a very interesting one and merits further research.

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Table 1
Results of surveylogistic regression for the following model:
IFRS Response[@] = Size^{@@} + Debt-to-Equity[#] + Return-on-Equity^{##}

	Expected signs	Observed signs	Value
Model Pr>ChiSq	N/A	+	0.2056
Size	+	+	0.2013*(1)
Debt-to-equity	+	+	0.0677**
Return on Equity	-	-	-0.2351**

Number of observations =203 (63 responded “no,” 34 responded “no-preference,” and 106 responded “yes”). Six CFOs who completed our survey did not respond to this question.

Notes:

N/A Not applicable

*, ** Significance at 0.1 and 0.05 respectively.

(1) The Wald Chi-Square test statistics includes 1; as such we fail to reject the null hypothesis (at 0.05 level) that Size coefficient is zero given the other predictors in the model. Also, the model shows that Size variable is only significant at 0.1 level.

@ = IFRS Response is the CFOs response to the following question:

Does your firm want to have the option to choose between IFRS and U.S. GAAP for financial reports filed in the U.S.? No ___ No-Preference ___ Yes ___

@@= Log of total assets (Compustat Data6)

= Long-term debt divided by total equity (Compustat Data9/Compustat Data216)

= Net Income (&&&&) divided by total equity (Compustat Data172 /Compustat Data216)

Our results hold even if we include only one independent variable (or any combination of two independent variables) at a time.

Table 2

Results of surveylogistic regression for the following two models:

To Question: If you were given the option, would you adopt fair value for non-financial assets?

Panel A:

$$\text{Asset Response}^{\textcircled{a}} = \text{Size}^{\textcircled{a}\textcircled{a}} + \text{Debt-to-equity}^{\#} + \text{Return on Equity}^{\#\#}$$

Panel B:

$$\text{Asset Response}^{\textcircled{a}} = \text{Size}^{\textcircled{a}\textcircled{a}} + \text{Debt-to-equity}^{\#} + \text{Return on Equity}^{\#\#} + \text{FAS ratio}^{\textcircled{a}}$$

	Panel A (number of observations = 207, 164 no, 24 undecided, 19 yes responses)			Panel B (number of observations = 134, 105 no, 13 undecided, 16 yes responses)		
	Expected signs	Observed signs	Value	Expected signs	Observed signs	Value
Model Pr>ChiSq	N/A	+	0.0577	N/A		0.0803
Debt-to-equity	+	-	-0.0563*(1)	+	-	-0.0581*(1)
Return on Equity	-	-	-0.3349***	-	-	-0.3456***
FAS ratio	Not incl.	N/A	Not incl.	-	-	-0.00687***

Notes:

Two respondents did not answer this question.

N/A = Not applicable

* and *** = Significance at 0.1 and 0.01 respectively.

(1) = The Wald Chi-Square test statistics includes 1; as such we fail to reject the null hypothesis (at 0.05 level) that Debt-to-Equity coefficient is zero given the other predictors in the model. Also, the model shows that Debt-to-Equity variable is only significant at 0.1 level and in a wrong direction.

@ = "No," "Do not know," or "Yes"

@@ = Log of total assets (Compustat Data6)

= Total debt divided by total equity (Compustat Data6/Compustat Data216)

= Net Income (&&&&) divided by total equity (Compustat Data172/Compustat Data216)

\$ = Information for "Level 2 and Level 3 assets and liabilities" was collected from 10-Qs. When 10-Qs did not disclose this information, we assumed that the data was missing instead of assigning a zero to the variable. We lost 73 observations to missing data. We added level 2 and level 3 assets (and liabilities) and scaled the results by the firm's total assets. The resulted ratios (one for assets and one for liabilities) were added and are used in this model.

Size of the company did not influence the CFOs' responses. Inclusion of the Size variable did not change our results.

Our results hold even if we run the regression with one independent variable (or any combination of two independent variables) at a time.

Table 3
Results of surveylogistics logistics regression
for question: Do you intend to use fair value option for long-term liabilities?

Panel A:

$$\text{Liab. Response}^{\textcircled{a}} = \text{Size}^{\textcircled{a}\textcircled{a}} + \text{Debt-to-equity}^{\#} + \text{Return on Equity}^{\#\#}$$

Panel B:

$$\text{Liab. Response}^{\textcircled{a}} = \text{Size}^{\textcircled{a}\textcircled{a}} + \text{Debt-to-equity}^{\#} + \text{Return on Equity}^{\#\#} + \text{FAS ratio}^{\textcircled{\$}}$$

	Panel A (number of observations = 204, 183 no, 21 yes responses)			Panel B (number of observations = 134, 117 no, 16 yes responses)		
	Expected signs	Observed signs	Value	Expected signs	Observed signs	Value
Model Pr>ChiSq	N/A	+	?	N/A		?
Debt-to-equity	+	-	-0.0658**	+	-	-0.0674**
Return on Equity	-	-	-0.2899**	-	-	-0.3021**
FAS ratio	Not incl.	N/A	Not incl.	-	+	0.0448* (1)

Notes:

Five respondents did not respond to this question.

N/A = Not applicable

* and ** = Significance at 0.1 and 0.05 respectively.

(1) = The Wald Chi-Square test statistics includes 1; as such we fail to reject the null hypothesis (at 0.05 level) that Level 2 and Level 3 assets and liabilities coefficient is zero given the other predictors in the model. Also, the model shows that Level 2 and Level 3 assets and liabilities variable is only significant at 0.1 level and in a wrong direction.

@ = “No,” “Do not know,” or “Yes”

@ @ = Log of total assets (Compustat Data6)

= Total debt divided by total equity (Compustat Data9/Compustat Data216)

= Net Income (&&&&) divided by total equity (Compustat Data172/Compustat Data216)

\$ = Information for “Level 2 and Level 3 assets and liabilities” was collected from 10-Qs. When 10-Qs did not disclose this information, we assumed that the data was missing instead of assigning a zero to the variable. We lost 73 observations to missing data. We added level 2 and level 3 assets (and liabilities) and scaled the results by the firm’s total assets. The resulted ratios (one for assets and one for liabilities) were added and are used in this model.

Size of the company did not influence the CFOs’ responses. Inclusion of the Size variable did not change our results.

Our results hold even if we run the regression with one independent variable (or any combination of two independent variables) at a time.

Table 4
Reasons for response to question on the use of the fair value option for non-financial assets.
N = 209

Panel A: Reasons for responding “Yes,” intend to adopt fair value for non-financial assets.

Rank/Score	Description
1/90	Fair value will provide better picture of our firm’s position.
2/63	Fair market value is here to stay and we need to use it now or in the near future.
3/49	Fair value will provide lower cost of capital without regards to what others are doing
4/45	We have to use fair value, since the competition is doing it and not doing it will put us at a disadvantage.

Panel B: Reasons for responding “No,” do not intend to adopt fair value for non-financial assets.

Rank/Score	Description
1/822	The cost of determining fair value is too prohibitive.
2/819	The benefit of using fair value is unknown.
3/801	Fair value will confuse the users of our financial statements.
4/744	Fair value will introduce fluctuations in the balance sheet that we do not want
5/678	The effect of using fair value on the income statement is unknown.
6/660	Required disclosures are too cumbersome.
7/402	The market sees through accounting numbers, so the choice of accounting method is irrelevant
8/372	The competition does not use fair value for long term assets.
9/282	Fair value will adversely influence our debt or bonus contracts.

Note:

In the rationale section of our survey, we asked respondents to rank the importance of reasons why they selected yes or no on a Likert-like scale from one (most important) through five (least important). In order to facilitate comparisons among the reasons, we computed a single score for each reason by assigning linearly descending weights to the individual responses as follows: five points for the most important reason, four points for the second-most important, three points for the third-most important, two points for fourth-most important, and one point for the least important. We simply added the points for each reason to obtain the score. We ranked the reasons according to the score and also report the score.

Table 5
Reasons for response to question on using fair value for long-term liabilities (N=209)

Panel A: Reasons for responding “Yes,” intend to use the fair value option for long-term liabilities.

Rank/Score	Description
1/81	Fair value will provide better picture of our firm’s position.
2/78	Fair market value is here to stay and we need to use it now or in the near future.
3/54	Fair value will provide lower cost of capital without regards to what others are doing.
3/48	We have to use fair value, since the competition is doing it and not doing it will put us at a disadvantage.

Panel B: Reasons for responding “No,” do not intend to use the fair value option for long-term liabilities.

Rank/Score	Description
1/837	The cost of determining fair value is too prohibitive.
2/825	Fair value will introduce fluctuations in the balance sheet that we do not want.
3/810	Fair value will confuse the users of our financial statements.
4/765	The benefit of using fair value is unknown.
5/735	The effect of using fair value on the income statement is unknown.
6/660	Required disclosures are too cumbersome.
7/565	The market sees through accounting numbers, so the choice of accounting method is irrelevant.
8/435	The competition does not use fair value for long term assets.
9/324	Fair value will adversely influence our debt or bonus contracts.

Note: See note accompanying Table 4