ABSTRACT

Relevance of supplementary fair value disclosures under market uncertainty: Effects on audit fees and investors' pricing

Laura Mehnaz

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Fair value (FV) means the market value of an asset, which can be observed directly (Level 1), or indirectly (Level 2). In some cases, the FVs are not observable in the market and managers of companies estimate the valuation internally using statistical models based on the best information available. These are known as Level 3 FV. The measurement uncertainty is the highest for Level 3 FVs as they rely on managerial discretion, creating concerns about their representational faithfulness and relevance among auditors and investors. This concern is likely to be heightened in the wake of market uncertainty during 2020 caused by the COVID pandemic. Regulators (e.g., ASIC) suggested that disclosing supplementary information (i.e., beyond the minimum required by regulation) on FV can help mitigate such concerns. In this study, I examine the relevance of supplementary disclosures intended to improve the representational faithfulness and relevance of Level 3 FV by investigating their impacts on audit fees and investors' valuation in the uncertain market condition of 2020. My sample comprises Level 3 investment properties held by Australian real estate companies. I find that managers of real estate companies increased supplementary FV disclosures during 2020. I document a negative association between supplementary disclosures and audit fees, implying that disclosures reduce the audit risk effect by signalling higher transparency. However, I find no incremental impact of disclosures on audit fees during the pandemic. Additionally, I find that investors' pricing of FV increased with the increase in disclosures during the market uncertainty of 2020, while in the pre-uncertainty period, their pricing influence was not significant. The findings of this study inform regulators and other financial reporting stakeholders about the role of supplementary

FV disclosures in mitigating the perceived audit risk for auditors and the faithful representation concerns for investors in a distressed market environment.