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Fair value accounting and corporate cash holdings

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ABSTRACT

A trade-off often exists between relevance and reliability of accounting numbers. Prior research suggests that fair value accounting increases the relevance and decreases the reliability. The reduced reliability may lead to more agency conflicts. We predict a positive relation between the use of fair value inputs and the level of corporate cash holdings because prior research links more agency conflicts to a higher level of cash. We find that increased use of fair value inputs is associated with a higher level of cash holdings, and the results are mainly driven by Level 1 and Level 2 fair value inputs. In addition, we find that our results are stronger for firms with more-able managers.

1. Introduction

Fair value accounting has received tremendous attention in academic research since the early 2000s. In 2006, the Financial Accounting Standards Board, 2006 (FASB) issued a significant standard, Accounting Standards Codification 820, (ASC 820), *Fair Value Measurement*. ASC 820 requires that firms using fair value inputs (assets and liabilities) disclose fair value inputs by levels. Specifically, Level 1 fair value inputs have the highest level of measurement certainty, and Level 3 fair value inputs have the lowest level of measurement certainty. A large body of prior research documents that the use of fair value inputs increases the relevance (e.g., Song, Thomas, & Yi, 2010) and reduces the reliability of accounting numbers (e.g., Allen and Ramanna, 2013), suggesting a trade-off between relevance and reliability.

Despite the surge of attention on fair value accounting, there is little empirical evidence on whether and how the use of fair value inputs relates to the level of corporate cash holdings. The purpose of this study is to examine the association between fair value inputs and corporate cash holdings. From the relevance-reliability trade-off perspective, if using fair value inputs reduces the reliability of accounting numbers, then investors may make wrong decisions because these numbers are less-credible and less-verifiable. In addition, a high level of managerial opportunistic or self-serving behavior is often involved in the use of fair value accounting (Watts, 2003). Both factors suggest that the reduced reliability may increase the agency conflicts between investors and managers. Thus, we argue that a positive association may exist between the use of fair value inputs and cash holdings because prior research (e.g., Oper, Pinkowitz, Stulz, and Williamson, 1999; Dittmar, Mahrt-Smith, & Servaes, 2003; Kalcheva & Lins, 2007) suggests that firms with more agency conflicts hold more cash.

We focus on cash in our study for the following reasons. First, cash is an important liquid asset on a firm's balance sheet. Myers and Rajan (1998) argue that managers often manipulate cash to engage in activities that are against shareholders' interests because of the liquid nature of cash. Second, anecdotal evidence suggests that the level of cash holdings has significantly increased recently. For example, the average cash-to-assets ratios have increased from approximately 11% in 1980 to 23% in 2006 (Bates, Kahle, & Stulz, 2009). It appears that more companies (i.e., Apple, Google, and etc.) hold a significant amount of cash. For example, Apple held $208 billion cash in 2015. Hence, understanding why firms hold large amounts of cash has been the focus of research in finance and accounting. Third, from an accounting perspective, cash is regarded as the most risky account, because a large number of accounting transactions flow through this account. Thus, different stakeholder groups such as shareholders and auditors pay extra attention to a firm's cash account (Whittington & Pany, 2015).

Using 24,741 firm-year observations from 2008 to 2015, we regress the level of cash holdings on the intensity of fair value inputs and control for other factors that may influence the level of cash holdings. We find a significant positive relation between the intensity of fair value inputs and cash holdings, suggesting that firms using more fair value inputs hold more cash. This evidence is consistent with our prediction that more use of fair value leads to more agency problems, leading to a higher level of cash. We further find that our results are mainly driven by Level 1 and Level 2 fair value inputs, as results show a significant relation between cash and Level 1 and Level 2 inputs. We do not find a significant positive relation between cash and the intensity of Level 3 inputs, which is regarded as the least reliable level (relative to

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