VALUE RELEVANCE OF IFRS13 FAIR VALUE HIERARCHY INFORMATION IN PALESTINIAN FINANCIAL INSTITUTIONS

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Abstract

This article aims to investigate whether fair value hierarchy affects value relevance of Palestinian portfolios, especially level three, due to unobservable inputs use on it. The researchers used regression model (logarithm regression) which mainly includes fair value levels as independent variables, and stocks price, for those companies have portfolios, as a dependent variable. The targeted population is the Palestinian financial organizations (14 institutions) that include portfolios under Palestine Exchange (PEX) from period 2011 to 2016 which is the most recent period. The article results showed that the fair value hierarchy significantly affects the relevance and reliability of information presented to the investor's, the mark-to-model fair value assets are significantly priced higher than mark-to-market fair value assets. Finally, level 3 gains do not reduce investors' pricing of Level 3 asset, due to the investor's trust in entities' information, since it is audited and disclosed in the financial reports in accordance with the requirements of standards.

Keywords: Fair value, Fair value hierarchy, level 3, mark-to-market fair value, historical cost, information

INTRODUCTION

Accounting measurement is a critical and controversial topic in preparing financial reports. Over 80 years ago, intellectuals and researchers adopted various methods to measure the elements of financial statements; historical cost and fair value were the methods most widely used (Christensen & Nikolaev, 2013, pp.1-2;Majercakova& Skoda, 2015, p.17).

Holzman & Robinson (2004, p. 1) found a historical cost which is may be the most reliable and objective measurement tool; however, not the most relevant one. Landsman (2007, p. 6) pointed out that fair value is more informative if it is compared with historical cost. FASB and IASB have outweighed relevance over reliability which lead boards to issue special standards for fair value (Christensen & Nikolaev, 2013, p. 7).

Fair value was gradually developed by accounting standard setters. For example, Financial Accounting Standard Board (FASB) was the first to use it through issuing related standards like: SFAS107, SFAS115, and SFAS113 (Jones & Stanwick, 1999, p. 2). In September 2006, the board issued SFAS157 which became a single source for other SFAS that use fair value (Board, 2007, p. 5).

The International Accounting Standard Board (IASB) proceeded a similar path to FASB in developing fair value by issuing IAS 32, and IAS39 (Jones &Stanwick, 1999, p. 4). In May 2012, IASB issued IFRS13 under the title of Fair Value Measurement. One of the most important purposes of IFRS13 is to improve consistency and reduce complexity in fair value applications, in addition to enhancing disclosures to enable users of financial reports from making decisions. As a result, IASB developed fair value hierarchy. This hierarchy includes three levels of inputs: level one which depends on quoted prices in an active market; level two which depends on inputs other than quoted prices used in level one that are observable for assets and liabilities; and level three which includes unobservable inputs for the assets and liabilities (Picker et al., 2012, pp. 68-69).

In 2007, all Palestinian listed companies under Palestine Exchange were required to prepare their financial statements according to IFRS which confirms that PEX are committed to their vision statement to enhance the secure trading environment, by following the best standards used all around the world (Abu Dieh, 2015, p. 17).

In 2010, The World Bank studied whether the financial reports of 11 Palestinian listed companies was compatible with IFRS to find a high degree of compliance with IFRS among them (Abu Dieh, 2015, p. 17). Abu Mutair & Alnairab (2012, p. 83) emphasized the importance of financial information amongst investors and its effect on their decisions. Also, Abu Dieh (2015, p. 76) found that using IFRS enhances accounting information quality.

In 2008, Palestinian listed companies used IAS39 Financial Instruments: Recognition and Measurement, in order to have advantages like: improving user's decision quality, increasing efficiency of financial statements, recording transactions in more effective way, and classifying financial instruments in an organized manner (Al-Helw, 2009, p. 80).

Moreover, measuring portfolio by fair value according to IAS 39, lead to the improvement of the financial performance of the majority of Palestinian companies, and enhanced investors' trust (Younis, 2011, p. 110).

Thus, this article aims to study whether fair value hierarchy affects value relevance of measuring Palestinian portfolios, especially level three, due to unobservable inputs use on it, and answer the following question: Does fair value hierarchy enhance the information qualities in regards of either relevance or reliability (value relevance) used in measuring portfolios under Palestinian financial institutions?

Value Relevance of Fair Value Hierarchy

Sebastian, Danut, & Maria (2014, p. 308) pointed out that selection of accounting model and revaluation method were considered as an important reason for the financial crisis, which mainly happened in industrial sector, due to meet objectives of stockholders who were concerned over maximizing the company's equity, its share price and dividend. Indeed, that required a new accounting model other than historical cost which was the market value or 'fair value'. On the other hand there was other researchers like Alkababji (2016, p.65) who said that using fair value accounting was one of the most important reason for the financial crisis in banking sector.

Although most companies preferred to use historical cost, they were required to apply fair value to enhance the comparability among companies listed in capital market. Improving the comparability and consistency of fair value as a measurement and disclosure tool required both boards to developing the fair value hierarchy which has three levels depend on the type of inputs, whether it is observable or unobservable. Accordingly, the fair value is a powerful disclosure tool as it plays a great role in increase transparency which leads to encourage the current stockholder, potential investors, and other stakeholders because it depicts and explains which kind of inputs, assumptions and technical methods were used in the measurement (Majercakova& Skoda, 2015, p. 6).

Researchers found out many factors effect on value relevance of fair value hierarchy. For example, Magnan (2009, pp. 200-202) said the market conditions play important role in determining the relevance and reliability of fair value, even when the market condition is liquid and stable. So, if the market is suffering from lower level of efficiency and high level of illiquidity, the fair value would provide a misleading information, especially if it is based on the input of

level 2, and level 3 which requires investors to discount the fair value due to its reliance on other than observable inputs and the management's judgment (Goh, Li, Ng, & Yong, 2015, p. 3) Also Song, Thomas, & Yai (2010, p. 1404)pointed out that the value relevance of fair value differs with the quality of corporate governance, in other words, when the corporate governance be weak, then the value relevance will be lower than expected especially level 3 will be near non relevance, but when corporate governance be strong, then the value relevance will be meet.

Both levels have been received attention by both boards and researchers, especially level 3, due to its reliance on firm's estimation which makes it the riskiest level in fair value hierarchy. Moreover, it usually provides ambiguous results which are hardly to express and interpret to be able to diagnose the situation of the firm and compare it with other firms. It is also not easily verified by the auditors, and usually has high level of information asymmetry and information risk (Goh et al., 2015, p. 5).

Consequently the FASB and IASB request companies to present additional disclosures, if the input belongs to level 3 (Goh et al., 2015, p. 4). Kolev (2009, p. 1) pointed out that level2 and level 3 could reflect the private information which creates a strong set of financial statements that help investors in making their decisions.

Applying International Financial Reporting Standards in Palestine

Many researchers investigated the effect of adoption International Financial Reporting Standards (IFRS) on the quality of financial statements in Palestine, such as (Garboua & Heles, 2005, p.37), who analyzed and evaluated the using of IFRS in presenting and disclosing financial statements in banks and financial institutions, they found out that applying IFRS contributes to reducing the likelihood of problems expected when reviewing the financial statements and attracting foreign investors. In addition, (Abu Dieh, 2015, p.66-68) made a comparison between pre-adoption period and the post-adoption period, she found the majority of studied standards enhances quality of financial statements, declines earning management, decreases timely loss recognition and improves value relevance. As well as, (Abu-Sharbeh, 2017, p.27) who stressed over the readiness of Palestinian practitioners and academics to accept IFRS in their jobs. Despite of the required budget for the conversion from US GAAP to IFRS.

As for the effect of applying fair value accounting, (Al-Najar, 2013, p.22) made a study of the impact of applying fair value accounting (FVA) on the reliability and appropriateness of financial statements information issued by the Palestinian corporations, he said that the adoption of FVA, increases the value relevance of financial information. Although many challenges face its application, for example, lack of efficient and active market for most assets,

a burden budget required to adopt fair value accounting and misinterpretation of financial information.

In addition, (Al-Kababji, 2016, p.83) studied the extant of compliance with disclosure requirements for fair value measurement (IFRS 13) in Palestinian corporations, by using a disclosure score called unweighted fair value disclosure index (FVDI), *which is the ratio of the value of the number of items a company discloses divided by total value that it could disclose.* He found out direct relationship between the size of the firm and the level of compliance with the disclosure requirements for fair value measurement of the firms, no correlation between the profitability of the firm and the level of compliance and direct relationship between type of auditor and level of compliance with the disclosure requirements for fair value measurement of the firms.

RESEARCH METHODOLOGY

Various methodologies have been used through related researches and articles. Barth was one of the first researchers who adopted the value relevance approach (Barth, Beaver, & Landsman, 2000, p. 9) which is based on studding how stocks prices reflect relevance and reliability of fair value (Barth, 1994, p. 1). Song et al. (2010, p. 1388), Goh et al., (2015, p. 9) and others were interested in studying the relevance value of fair value hierarchy by using the following methodology.

This regression will be used to test the first hypothesis which aims to investigate the value relevance of fair value hierarchy.

$Price_{i, t} = b_0 + b_1 FVA1_{i, t} + b_2 FVA2_{i, t} + b_3 FVA3_{i, t} + b_4 NFVA_{i, t} + b_5 NFVL_{i, t} + b_6 FVL12_{i, t} + b_7 FVL3_{i, t} + b_8 EPS_{i, t} + e_{i, t}$

The second regression investigates the effect of fair value hierarchy, especially level 3, on stock price (value relevance):

$Price_{i, t} = c_0 + c_1 FVA1_{i, t} + c_2 FVA2_{i, t} + c_3 FVA3_{i, t} + c_4 NFVL_{i, t} + c_5 FVL12_{i, t} + c_6 FVL3_{i, t} + c_7 LVL3GAINS_{i, t} + c_8 LVL3GAINS * FVA3_{i,t} + e_{i, t}$

Research approach

In this research, the" value relevance" approach is utilized to investigate the value relevance of fair value hierarchy, which is adopted by (Barth, 1994, p.1; Francis and Schipper, 1999, 319-352). Under this perspective, accounting number is value relevance when it has the influence on stocks' price, otherwise it is not.

The researchers has built a hypothetical system contained past researches, hypotheses and discoveries. This system goes into profundity about the idea of value relevance and

examines the part of accounting direction in value relevance investigation. In order to provide the related financial parties (Companies, stockholders, stakeholders and others) with adequate knowledge into the field of value relevance of fair value .

To achieve this goal, the researchers chose to collect information from all financial institutions listed on Palestine Exchange (PEX). The information gathered includes stock price, earning per share (EPS) and financial information related to fair value hierarchy.

Since the fair value hierarchy is the subject of matter, thus the International Financial Reporting Standard (13) "Fair Value Measurement" has to be utilized. To meet the disclosure requirements, the accompanying least exposures are required for each class of assets and liabilities measured at fair value (counting estimations in view of fair value inside the extent of IFRS). Take note that these requirements have been summarized in IFRS 13, Paragraph 72-99 and additional disclosure is required where necessary. Knowing that in Palestinian case, there is no financial liabilities could be measured by fair value.

Research Variables

To understand the previous regressions, the researchers depends on literatures review, to define variables as follows:

Table (1): Key research's variables

Variable	Definition	Measured by
Price	The close stock price Immediately after financial reporting.	The close stock price immediately after financial reporting that is addressed in Palestine exchange (Goh et al., 2015, p. 9 ; Song et al., 2010, p. 1388)
B0	The portion of other unmeasured independent variables.	Run the regression model (Goh et al., 2015, p. 9).
FVA1(FVA2, FVA3)	Net assets that are classified in level 1 (level 2, and level 3)	Net assets that are disclosed in financial notes and Presented in financial statement (Goh et al., p.6, 2015; Song et al., 2010, pp. 1387-1390).
FVA	Net assets fair value	Summing FVA1, 2, and 3 (Song et al., 2010, pp. 1387- 1390).
Book value of equity (net assets)	Amount is theoretically received by investors if the liabilities deducted from assets.	Book value of equity that are presented in financial statement, or book value of equity = assets – liabilities (Goh et al., 2015, p. 9).
NFVA	Net assets that are not market at fair value.	NFVA=Book value of equity (net assets) – FAV (Goh et al., 2015, pp. 9-12).

TL	Total liability.	TL = Assets – equity, It usually does not need to be calculated as it is already available in the financial position statement (Goh et al., 2015, pp. 9-12).
FVL1, 2, and 3)	Net liability that is classified in level 1 (level 2, level 3)	Summing liabilities that Classified in level 1, 2 and 3 (Goh et al., 2015, pp. 9-12).
NFVL	Net liabilities that are not marked at fair value.	NFVL = TL - FVL1, 2, and 3.
FVL12	Fair value for liabilities classified in level 1 and 2	Summing FVL1, and 2 (Goh et al., 2015, p. 6 ; Song et al., 2010, p. 1388)
EPS	Earnings per share which means the portion of the company's profit that is allocated to each outstanding share of common stock.	EPS=(net income - dividends) /outstanding shares. It usually does not need to be calculating as it is already available in the income statement (Goh et al., 2015, pp. 9-12).
LVL3GAINS	Dummy variable	One for companies with level three gains, and zero for those companies without level three gain (Goh et al., 2015, p. 14).
i, t	For company i in year t.	There is no measurement tool, it represents the name of the company and the year of data which is from 2011 to 2016 (Goh et al., 2015, pp. 9-12).
b, c	Coefficients.	Run the regression model.

EMPIRICAL RESULTS

Hypothesis testing

The first hypothesis

Aim to study the value relevance of fair value hierarchy by testing of the effect of all fair value's levels on the stock price as: H0: investor's pricing of levels 1, 2, and 3 asset estimates is the same across different market conditions in all Palestinian financial institutions.

To test this hypothesis, and to detect the value relevance of fair value hierarchy, the researchers needs to study the effect of all fair value levels on the stock price in Palestinian financial institutions from 2011 to 2016, the (logarithm regression) analysis was used, since the researchers needs to maintain high level of consistency between dependent and independent variables.

The liabilities variables have been eliminated, in order to there is no liabilities are measured by fair value.

$Price_{i,t} = b_0 + b_1 FVA1_{i,t} + b_2 FVA2_{i,t} + b_3 FVA3_{i,t} + b_4 NFVA_{i,t} + b_5 EPS_{i,t} + e_{i,t}$..... (1)

Table (2): the result of the (logarithm Regression) analysis of investigating
the value relevance of the fair value hierarchy

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	9.726158	6.799593	1.430403	0.1781
L_FVA1	-0.244787	0.181333	-1.349934	0.2020
L_FVA2	-0.467292	0.471210	-0.991687	0.3409
L_FVA3	0.310089	0.140428	2.208168	0.0474
EPS	-2.204907	5.062720	-0.435518	0.6709
NFVA	1.13E-09	3.49E-09	0.323802	0.7517
	Weighted Statistics			
R-squared	0.828738	Mean dependent var		3.236667
Adjusted R-squared	0.757379	S.D. dependent var		1.414733
S.E. of regression	0.696849	Sum squared resid		5.827186
F-statistic	11.61362	Durbin-Watson stat		0.560832
Prob(F-statistic)	0.000292			

Table 2 reports the regression results based on Eq (1). In order to investigate the differences in the pricing of these assets, the researchers conducts F-statistic test for the population.The result is the null hypothesis is rejected, which means investor's pricing of levels 1, 2, and 3 asset estimates is not the same across different market conditions in all Palestinian financial institutions.

In addition, the coefficients across the fair value hierarchy FVA1, FVA2 and FVA3 are -0.244787, -0.467292 and 0.310089 respectively. Likewise, the results show that investors' price mark-to-model assets (Level 3 estimates) significantly higher than mark-to-market assets (Level 1 and Level 2 estimates). Hence, it appears that investors perceive reliability concerns with respect to the valuation of Level 1 and 2 instruments in Palestinian case.

Thus, the researchers conclude that mark-to-model fair value assets based on unobservable inputs (Level 3 assets) are significantly priced higher than fair value assets based on observable inputs (Level 2 assets) and mark-to-market fair value assets (Level 1 assets).

Then, level 3 assets are significantly and positively affected on the price. Given that mark-to-market assets are carry higher information risk compared to mark-to-model assets, it appears that investors are pricing these assets lower because of concerns about availability of asset's price. It could also be due to the fact that Level 3 inputs are unobservable and generated by the entity itself, whereas Level 1 and Level 2 inputs are observable, because they are taken directly from the market or from data adjusted for similar items traded in active

markets, which means that Palestinian investors do not trust in Palestinian market and its information.

The Price variable is explained by 75% of changes in independent variables based on adjusted R-squared. Thus, the regression equation will take the following form:

PRICE = 9.726158 -0.244787*FVA1 -0.467292*FVA2 + 0.310089*FVA3 + 1.13E-09* NFVA - 2.204907*EPS

The second hypothesis

Aims to investigate the effect of fair value hierarchy, especially level 3, on stock price, the hypothesis as: H0: Level 3 gains reduce investors' pricing of Level 3 asset estimates.

To test this hypothesis, and to detect the effect of level 3 on stock price (value relevance) in Palestinian financial institutions from 2011 to 2016, the (logarithm regression) analysis was used, since the researchers needs to maintain high level of consistency between dependent and independent variables.

The liabilities variables have been eliminated, in order to there is no liabilities are measured by fair value.

Price i, t = c0 + c1FVA1i, t + c2FVA2i, t + c3FVA3i, t + c4LVL3GAINS i, t + c5 LVL3GAINS * FVA3i, t + ei, t …. (2)

Table (3): The result of the (logarithm Regression) analysis of effect of fair value hierarchy

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	11.08169	4.599254	2.409454	0.0329
L_FVA1	-0.253164	0.056958	-4.444732	0.0008
L_FVA2	-0.551373	0.289166	-1.906770	0.0808
L_FVA3	0.285495	0.087437	3.265143	0.0068
LVL3GAIN	0.170035	0.472757	0.359667	0.7253
LVL3GAINS*FVA3	-3.39E-08	1.88E-07	-0.180679	0.8596
Weighted Statistics				
R-squared	0.826510	Mean dependent var		3.236667
Adjusted R-squared	0.754222	S.D. dependent var		1.414733
S.E. of regression	0.701368	Sum squared resid		5.903011
F-statistic	11.43362	Durbin-Watson stat		0.449771
Prob(F-statistic)	0.000314			

Table 3 reports the results of estimating Eq. (2). The finding is the null hypothesis is rejected, which means Level 3 gains do not reduce investors' pricing of Level 3 asset estimates. Moreover, the coefficient and probability of LVL3GAINS and LVL3GAINS xFVA3 indicate that the gain of fair value level 3 do not affect investor's pricing of level 3.

Thus, the investor's trust in entities' information, since it is audited and disclosed in the financial reports in accordance with the requirements of standards. This finding is consistent with the results of FVA1, FVA2 and FVA3 coefficients are -0.253164 (t-statistic: -4.444732, P: 0.0008), -0.551373 (t-statistic: -1.906770, p: 0.0808) and 0.285495 (t-statistic: 3.265143, p: 0.0068) respectively, which indicate again that the value relevance of fair value is significantly greater in fair value level 3.

The Price variable explained what the amount of 75% of changes in dependent variables based on adjusted R-squared. Thus, the regression equation will take the following form:

PRICE = -0.253164 *FVA1 - 0.551373 *FVA2 + 0.285495 *FVA3 + 0.170035LVL3GAINS i, t - 3.39E-08 LVL3GAINS * FVA3i, t

DISCUSSIONS

The previous results are Consistent with the results documented in Magnan (2009, pp. 200-202) who said that the market conditions play important role in determining the relevance and reliability of fair value. Barth (1994) who said that the investors discount fair value when it is used in less healthy companies or on less healthy market. Majercakova & Skoda (2015, p. 10) who found out that the relevance value of fair value depends on the nature of the subject, and the source of information. Moreover, Kieso, Weygandt, & Warfield (2011, pp. 513-583) state that market's statues is not always suitable to provide companies with the reliable value for quoted price especially if the market was inefficient. Also, Al-Najar (2013) who said that the lack of efficient and active market for most assets is one of the most important challenges that face value relevance of fair value in Palestinian market. But it does not consistent with Barth (1994) and Holzmann & Robinson (2004), who said there is a decline in the weight that investors placed on financial institutions fair value assets as we move across the three-level fair value hierarchy. It may be due to the tested market (U.S market).

The researchers may explain the second hypothesis result, by referring to what Goh et al. (2015) said "The coefficients on LVL3GAINS FVA3 are statistically insignificant at the conventional levels, suggesting that the magnitude of fair value gains and losses does not lead investors to price Level 3 asset estimates differently. One possible explanation for this result is that the discounting for the Level 3 asset estimates is due to concerns about a general lack of reliability in the fair value estimation of illiquid assets, as opposed to concerns about managers'

misuse of fair value estimates to inflate earnings and asset values. The fact that managers have to explicitly report the audited details about the changes in the value of Level 3 assets (and liabilities)".

Thus, the investors trust in entities' information, since it is audited and disclosed in the financial reports in accordance with the requirements of standards. This finding is consistent with the results of Landsman (2007, p. 24) who found that the management has good knowledge about their assets which averts personal interest and provides a reliable judgment, Barth & Clinch (1998, pp. 330-331) who said that reliance on management information requires an independent person should reevaluate assets. In contrast with Kolev (2009, pp. 1-2) who states that the entity's management would use its ability to manipulate the fair value.

CONCLUSION

The researchers sum up the research's result in the following points:

- The fair value hierarchy significantly affects the relevance and reliability of information presented to the investor's.
- The mark-to-model fair value assets are significantly priced higher than mark-to-market fair value assets, this due to:
- Lack of efficient and effective market.
- Deficient knowledge of fair value.
- Fair value level 3 significantly affect the value relevance of financial information compared to other levels, this due to :
- The lack of investor's trust in market information.
- Management's knowledge is reflected in fair value.

RECOMMENDATIONS

In the light of the results, following recommendations are suggested:

- Improve Palestinian capital market, to restore investor's trust.
- Maintain management transparency and governance.
- Increase investor's awareness of the fair value.
- Additional research should be carried out to gain a continuous view, knowledge, and insight of Value relevance of IFRS 13 fair value hierarchy information in Palestinian institution.
- Conducting similar studies, and applying the fair value, on a larger population of Palestinian institutions'.

- There is a need for researchers to continue carrying out financial institutions' as fair value hierarchy.

LIMITATIONS

This study just like other studies suffers from some limitations:

- Obtaining the study data was only from a single source (i.e. Only annual reports from six consecutive years in Palestinian financial organizations); and it would be better if multiple years (longer time series) were used.

- The data for this study were confined on the Value relevance of IFRS 13 fair value hierarchy information in one country.

- This research's measurement results were acceptable in terms of reliability and validity, but there is certainly a need for additional work to perfect measures, Future research can be conducted to overcome these limitations.

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