

Fair Value versus Non-fair Value Discretion and Auditing

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Abstract: I exploit security-level disclosures in the insurance industry to examine auditors' role in managers' choice between using discretion related to fair value measurements ("fair value discretion") and discretion unrelated to fair value measurements ("non-fair value discretion") to manage the same accounting estimate—other-than-temporary-impairment (OTTI) losses. Employing within-security analyses to control for differences in clients' financial security holdings, I find that insurers audited by a Big 4 audit firm are more likely to use non-fair value discretion versus fair value discretion to avoid recognizing OTTI losses, compared to those audited by a non-Big 4 firm. The effect is more pronounced when Big 4 firms have a greater advantage over non-Big 4 audit firms in auditing fair value estimates. Additional evidence confirms that, in the presence of Big 4 audit firms, insurers are more likely to dispose of a security identified as subject to OTTI avoidance through non-fair value discretion in the current period at a loss in the future. This result is consistent with insurers' greater use of non-fair value discretion by overstating their intent and ability to hold securities until the prices recover in the presence of a Big 4 audit firm. The findings of this study suggest that auditors can differ in their relative ability to constrain managers' fair value and non-fair value discretion, which play a role in shaping managers' trade-offs between using the two types of discretion in OTTI avoidance.

Keywords: ; Accounting choice; Other-than-temporary impairment; Fair value discretion; Non-fair value discretion; Insurance companies; Big 4 audit firms;

JEL classification: G22, M41, M42