



COMPREHENSIVE INCOME REPORTING: THE IMPLICATION OF AUDITOR'S REPUTATION AND AUDIT COMMITTEE EFFECTIVENESS

¹Aliyu Baba Usman (PhD)
(ubabaali3131@gmail.com)
+234-8065808572

&

²Isah Yahaya Danladi
(isahdyahaya@gmail.com)
+2348034504618

&

³Ndagi Salihu
(ndagisaliu@gmail.com)
+2348036935658

&

⁴Ejike Sunday Okoroigwe (PhD)
(ejikesunday@gmail.com)
+2348067375891

^{1,2,3&4} Department of Accounting, Faculty of Management and Social Sciences
Ibrahim Badamasi Babangida University Lapai, Niger State, Nigeria

Abstract

Both International Accounting Standard Boards (IASB) and Financial Accounting Standards Board (FASB) require companies to mark-to-market certain financial assets and liabilities and to recognize related gains and losses as Other Comprehensive Income (OCI). When an active market (quoted prices) for other comprehensive items does not exist, valuation techniques that employ observable or unobservable market data are used. Valuation techniques based on observable or unobservable input require management assumptions and judgments, which has potentials for managerial opportunism. By calibrating Positive Accounting Theory (PAT) and agency theory, this paper offers a theoretical explanation of the implications of auditor reputation and audit committee effectiveness on investors' pricing of comprehensive income and its components. The paper believes this to be a distinct improvement over the views expressed in the literature about managerial discretions involve in the fair value determination of certain financial assets and liabilities and recognizing holding gains and losses.

Keyword: *Audit Reputation; Audit Committee Effectiveness, Comprehensive Income, Other Comprehensive Income.*

1. Background and Motivation

The periodic financial position and performance of reporting entity is determined according to the principle of dirty or clean surplus accounting. Major contention against clean surplus income calculation was the arbitrary manner in which substantial accounting amount elude disclosure on the face of income statement (Kanagaretnam, Mathieu, & Shehata, 2009; Lee & Park, 2013). On the other hand, dirty surplus approach contends that all changes in the value of assets and liabilities measured at their market value should pass through the income statement. Considering the magnitude of OCI items, the proponents of this doctrine calls for the display of Total



Comprehensive Income (TCI) and OCIs in separate section of income statement or a statement called statement of income to allow components of different character to be view and evaluated separately (Kanagaretnam et al., 2009; Lee & Park, 2013).

Eventually, these concerns led to the promulgation of Statement of Financial Accounting Standard (SFAS 130) –“Reporting of Comprehensive Income” – in 1997 and the revision of International Accounting Standard (IAS 1) – “Financial Statements Presentation” – in 2007 (Lee & Park, 2013; Mechelli & Cimini, 2014; Firescu, 2015). By these promulgations, companies are mandated to mark-to-market changes in revaluation surplus, gains and losses on re-measuring available-for-sale financial assets, foreign currency translation adjustments, actuarial gains and losses on defined benefit plans and effective portion of gains and losses on cash flow hedge (Kanagaretnam et al., 2009; Lee & Park, 2013; Mechelli & Cimini, 2014; Firescu, 2015). Presentation of these fair value adjustments aims to enhance the level of disclosure and transparency of financial statements and to provide capital markets participants with more relevant financial performance measures beyond the traditional net income. Since the components of OCI are to be visible on the face of primary financial statement, it will probably lessen the direct and indirect cost of valuation activities (Kanagaretnam et al., 2009; Lee & Park, 2013) and reduces earnings management (Kanagaretnam et al., 2009; Lee & Park, 2013; Mechelli & Cimini, 2014). Thus, some quota, including researchers and standards setters agreed that such could lead to a higher value-relevance of accounting data (Lee & Park, 2013; Mechelli & Cimini, 2014).

Nonetheless, some scholars dispute whether such accounting measurement is indeed helpful in achieving transparency, especially where the economic value of these assets and liabilities are determined using valuation based on models (Lee & Park, 2013). When an active market for fair value assets and liabilities does not exist, the value of OCIs is derived using observable and unobservable inputs following guideline on fair value determination prescribed in the International Financial Reporting Standard [IFRS] (Lee & Park, 2013; Mechelli & Cimini, 2014; Firescu, 2015).

Valuation techniques based on observable or unobservable inputs require management judgments and assumptions; this tends to be high for unobservable inputs (Lee & Park, 2013; Public Company Accounting Oversight Board [PCAOB], 2011). Thus, the variability in a managers choice of valuation methods, classification and timing of fair-value estimates of OCI may affect investors’ reliability of reported TCI and OCI (Jones & Smith, 2011; Turktas, Georgakopoulos, Sotiropoulos & Vasileiou, 2013). In this study, we provide a theoretical explanation on the implication of auditor’s reputation and audit committee effectiveness on investors judgments of firm value.

Given the efficacy of audit reputation and audit committee effectiveness on financial reporting, verification of the proposed model will be a response to calls in the literature for more in-depth single country studies (Barth et al, 2012), different institutional context (Habib, 2008; Oliveira et al., 2010) and IFRS adoption (Barth et al., 2008; Rad & Embong, 2013). It is also anticipated that verifying the proposed model will have a practical implication to policy makers, including accounting regulators and preparers on accounting and auditing practices. Similarly, finding from the proposed model will helps in increasing investors’ level of confidence on the quality of total comprehensive income and its components.



The remainder of this paper is organized as follows: section two presents the theoretical framework. We discussed the implication of auditor's reputation and audit committee effectiveness on the quality of TCI and OCIs in section three and section four is the conclusion.

2. Theoretical Framework

According to the positive accounting theory, the measurement perspective, even though provide limited explanations for accounting choices, gave much clarification and appropriateness of accounting numbers for market analysis (Kanagaretnam et al., 2009; Turktas, 2013). One important explanation could be that accounting choice deals more with the behavioral attitude of managers than just choice of accounting approach. While there are several motivations for firms to make accounting choices for economic based reasons, incentive to meet bonus plan, debt covenant as well as ownership structure may influence managers to technical misrepresent earnings from its economic reality (Lee & Park, 2013;). Consequently, actual results could differ materially from reported information and hence, creating additional challenges for users' and auditors of financial information [Lee & Park, 2013; Jones & Smith, 2011)]. For example, managers may elect measurement procedures that will lead to smooth earnings instead of volatile earnings. Given such possibility, comprehensive income reporting may add noise to financial reporting since its calculation may involve estimates that are more subjective and transitory in nature. Because of the volatility of OCI components, managers may use such transactions as an efficient tool to shift future earnings to the present time and vis-visa. This is consistent with behavioural research, which supports that managers have motivates to manage earnings in order not to hurt the firm's stock price.

More so, in an incomplete information and imperfect market condition, agency cost is a common threat that fraught the principal-agent relationship due to separation of ownership from control (Lee & Park, 2013). In such circumstance, agency theorists posit that maximizing the benefit and interest of the principal may not always be the motive of the agent. Been in control and has the responsibility of preparing financial statement, agents might use the advantage of been more informed than investors to misrepresent information for personal benefits. Because of separation of ownership from control, principal has limited capacity to monitor whether or not fair-value-based measurement of financial assets and liabilities and recognized gain and losses reflect the true and fair view of such transaction. Such scenario presents cases of information asymmetry, which tend to widened the gap between the managers and the investors (Francis & Michas, 2013) and deteriorate capital market efficiency (Francis & Michas, 2013; Woidtke & Yeh, 2013). In order to reduce agency cost associated with negative behavioural attitude of managers, commentators underscore the effectiveness of audit committee and reputable external auditors (Francis & Michas, 2013; Woidtke & Yeh, 2013). This argument stems from the knowledge, expertise and different skills possessed and exchanged between internal and external audit (Francis & Michas, 2013; Woidtke & Yeh, 2013).

Using PAT and agency theories as paradigm, Figure 1 provides an overview of our belief on the influence of audit reputation and audit committee effectiveness on the relationship between value relevance of TCI and OCI and market value of equities.

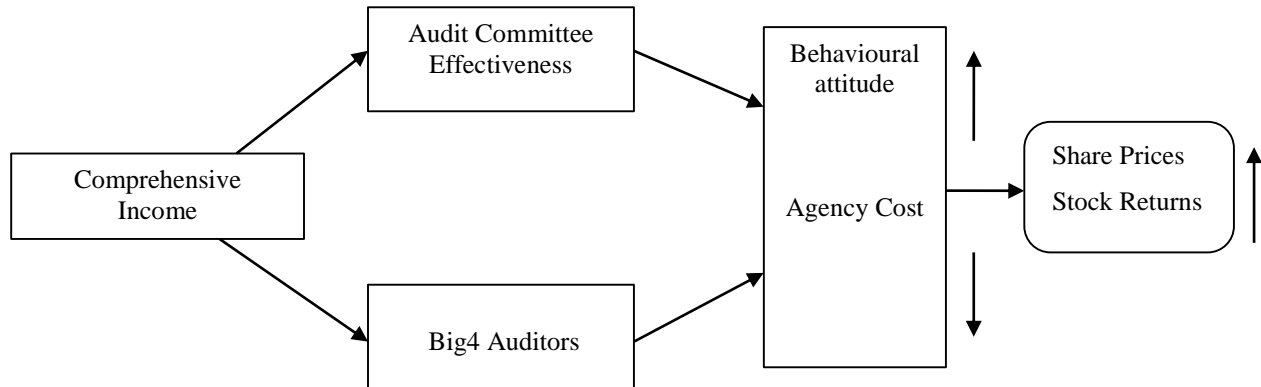


Figure 1: Theoretical model of the influence of audit reputation and audit committee effectiveness on investor' pricing of comprehensive income.

3. Implication of Audit Reputation and Audit Committee Effectiveness

The present accounting environment, which tilts towards fair value accounting, has rejuvenated reliability concern among researcher and standards setters. Lee and Park (2013) is the only study that we are aware of which examined the influence of auditor's reputation on investors pricing of TCI and OCI based on return model. In figure 1, we build upon (Lee & Park, 2013) and argue that high corporate governance standard ought to lead to positive behavioral attitude and low agency; and consequently higher firm valuation (Jones & Smith, 2011; Francis & Michas, 2013; Lee & Park, 2013).

Involvement of auditors in the process of financial reporting enhances the reliability of financial information (Lee & Park, 2013). Perceived ethical audit practices is positively correlated with higher accruals quality and lower material internal control weaknesses, significantly associated with a lower borrowing cost, curtail the incidence of financial reporting problems and stimulate a positive stock market reaction (Francis & Michas, 2013; Lee & Park, 2013) The general assumption is that external audit function can play a broader role to limit the opportunistic behavior of the managers from manipulating accounting numbers PCAOB, 2011; Francis & Michas, 2013; Lee & Park, 2013) suggesting reduced agency cost. Since other comprehensive income items are "mark-to-market" types of adjustments, the preparers and investors' may face difficulty on how managers established fair-value of such economic assets and liabilities (PCAOB, 2011). Recently, Lee and Park (2013) examine the effect of audit reputation on investors' pricing of total and other comprehensive incomes. However, being certified by reputable auditors, such accounting amount is perceived to be more reliable (Lee & Park, 2013). Their result indicates a significant valuation difference between Big4 and non-Big4 audit firms, particularly for more subjective items of comprehensive income. Thus, the impact of the audit reputation on the investors' judgment of reliability of accounting data is recognized.

Similarly, figure 1 demonstrates that serving as a monitoring mechanism, audit committee enhances quality of CI. Audit committee effectiveness is one of the components of corporate governance element frequently associated with the quality and integrity of the financial reporting (Yasin & Nelson, 2012; Woidtke & Yeh, 2013). Internationally, a best practice audit committee has been emphasized by several regulatory and legislative reforms such as the Blue Ribbon



Committee on Improving the Effectiveness of Corporate Audit Committees (BRC) 1999 and Sarbanes Oxley-Act 2002 (Yasin & Nelson, 2012; Woidtke & Yeh, 2013). As a requisite ingredient for effective monitoring, audit committee quorum should have a majority of independent directors, have at least one member with financial expertise, fulfills the minimum threshold of membership and meetings (Yasin & Nelson, 2012; Woidtke & Yeh, 2013). Available evidence suggests that audit committee effectiveness improves financial reporting quality by reducing incidence of earnings management, accounting irregularities and fraudulent reporting. Therefore, to the extent that audit committee scrutiny reduces the level of subjectivity and professional judgment involved in the financial reporting process, one might expect effective audit committee to be positively associated with the informativeness of TCI and OCI.

Consequently, afore discussed literature suggests that the presence of Big 4 auditors and effectiveness of audit committee shape both nonprofessional and professional investors' judgments of accounting quality subsequently positive market reaction.

4. Conclusion

This study is motivated by the managerial subjectivity in the fair value determination of TCI and OCI components. From the investor's viewpoint, previous studies unequivocally established the influence of audit reputation and audit committee effectiveness on the quality and reliability of financial information. Consequently, providing scholarly evidence on how audit reputation and audit committee effectiveness predictably affects investors' market equities judgments could provide useful input to policy makers and international standard setters.

References

- Francis, J. R., & Michas, P. N. (2013). The contagion effect of low-quality audits. *The Accounting Review*, 88(2), 521-552. doi:10.2308/accr-50322.
- Jones, D. A., & Smith, K. J. (2011). Comparing the value relevance, predictive value, and persistence of other comprehensive income and special items. *Accounting Review*, 86(6), 2047-2073. doi:10.2308/accr-10133.
- Kanagaretnam, K., Mathieu, R., & Shehata, M. (2009). Usefulness of comprehensive income reporting in Canada. *Journal of Accounting and Public Policy*, 28(4), 349-365. doi:10.1016/j.jaccpubpol.2009.06.004.
- Lee, C., & Park, M. S. (2013). Subjectivity in fair-value estimates, audit quality, and informativeness of other comprehensive income. *Advances in Accounting, incorporating Advances in International Accounting*, 29(2), 218-231. doi:10.1016 /j.adiac.2013.05.003.
- Mechelli, A., & Cimini, R. (2014). Is comprehensive income value relevant and does location matter? A European study. *Accounting in Europe*, 11(1), 59-87. doi:10.1080/17449480.2014.890777.
- Public Company Accounting Oversight Board (PCAOB) (2011). Report on observations of PCAOB inspectors related to audit risk areas affected by the economic crisis. Washington, D.C.
- Woidtke, T., & Yeh, Y. H. (2013). The role of the audit committee and the informativeness of accounting earnings in East Asia. *Pacific-Basin Finance Journal*, 23, 1-24. doi:10.1016/j.pacfin.2012.12.002.
- Yasin, F. M., & Nelson, S. P. (2012). Audit committee and internal audit: implication on audit quality. *International Journal of Economics, Management and Accounting*, 20(2), 187-218.