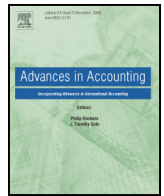




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Subjectivity in fair-value estimates, audit quality, and informativeness of other comprehensive income ☆☆☆

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ABSTRACT

This study empirically examines whether difference in audit quality is reflected in the pricing of other comprehensive income (OCI). Specifically, we first investigate whether OCI measures of Big 4 clients are more value-relevant than those of non-Big 4 clients. Considering different degrees of subjective management judgment involved in the OCI reporting process, we then explore whether the differential valuation effect of OCI between Big 4 and non-Big 4 clients is more pronounced for more subjective OCI components (e.g., minimum pension liability and foreign currency-translation adjustment) than a less subjective component (e.g., marketable securities adjustment). We predict that the aggregate OCI of a Big 4 client is more value-relevant than that of a non-Big 4 client. We also hypothesize that the differential valuation effect between Big 4 and non-Big 4 clients can be attributed to the amount of subjective assumption and judgment required in estimating OCI. Consistent with our predictions, we find that aggregate OCI audited by a Big 4 auditor has incremental information content over earnings, compared to OCI audited by a non-Big 4 auditor. More interestingly, our results also show that the differential valuation effect between Big 4 and non-Big 4 clients is stronger for OCI components of a more subjective nature. Our results are robust even after controlling for self-selection bias, the potential effect of the financial crisis, and other related effects.

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1. Introduction

The Financial Accounting Standards Board (FASB) requires firms to report comprehensive income as the sum of net income and other comprehensive income (OCI) (see Accounting Standard Codification (ASC) 220-10-45, pre-codification Statement of Financial Accounting Standards (SFAS) No. 130). This requirement raises debates about the informativeness of such items (e.g., Biddle & Choi, 2006; Chambers, Linsmeier, Shakespeare, & Sougiannis, 2007; Dhaliwal, Subramanyam, & Trezevant, 1999; Jones & Smith, 2011, among others). Moreover, the reporting of OCI is getting more attention because of the convergence of U.S. Generally Accepted Accounting Principles (GAAP) to International Financial Reporting Standards (IFRS).²

The current financial reporting environment raises concerns about the determination of fair-value measures, creating additional challenges for auditors and users of financial information (see Christensen, Glover, & Wood, 2012; Public Company Accounting Oversight Board (PCAOB), 2007b, 2011; SEC, 2008). OCI includes unrealized holding gains or losses on available-for-sale securities, gains or losses associated with pensions or other postretirement benefits, adjustments of foreign-currency translation, and gains and losses on derivative instruments that are designated as cash-flow hedges. Since OCI typically includes several “mark-to-market” types of adjustments, financial reporting of OCI may be subject to management’s assumptions and judgments. Specifically, managers can exercise discretion over the classification, timing, and choice of valuation methods, including key assumptions, when they determine the fair-value estimates of components of OCI. The Securities and Exchange Commission (SEC)’s Office of the Chief Accountant and the staff of the FASB provide guidance to investors, preparers, and auditors on the application of fair-value measurements in the current market environment (see SEC, 2008). According to this guidance, when an active market for a security does not exist, the use of management estimates is acceptable. Using judgment and subjectivity in estimating fair-value estimates significantly affects the quality of financial information because it may be subject to an inherent degree of uncertainty, and as a result, actual results could differ materially from the estimates. For instance, Dhaliwal et al. (1999) argue that

☆ Data used in this study are available from public sources identified in the paper.

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² Under IFRS, the magnitude and scope of OCI reporting is greater than that provided under U.S. GAAP, by allowing firms to write-up temporary changes in the fair value of assets and/or liabilities.

some components of OCI may involve more subjective estimates, thereby adding noise to financial reporting.

There is a widespread belief that because of the subjectivity of fair-value estimates, managers have incentives for substantial reporting judgment and discretion, and thus it is difficult for auditors to challenge. Recently, the PCAOB (Fall of 2011) issues a detailed report outlining certain high risk-audit areas and challenges that it identified during its regular inspections of registered accounting firms. Fair-value measurement is identified as one of the more significant high-risk audit areas in the PCAOB's report.³ Primary deficiencies identified by the PCAOB relating to the fair-value measurement of financial instruments include (1) whether fair-value measurements are determined using appropriate valuation methods; and (2) the reasonableness of management's significant assumptions used to measure fair value, such as discount rates, and credit loss expectations (see PCAOB, 2011). Especially, the PCAOB's report states that the attention and additional scrutiny directed towards these high-risk areas will be considerable. In addition, Mark Olson, the former chairman of the PCAOB, expresses concern about the challenges for assurance services related to fair-value estimates, saying that "The increased use of fair value accounting poses a challenge for auditors and the PCAOB" (PCAOB, 2007a). Considering the nature of OCI, which is mainly derived from fair-value application and subject to managerial judgment and discretion, subjective fair-value estimates of OCI should be of particular concern and scrutinized closely by auditors. Specifically, more extensive audit work on subjective OCI estimates will be necessary for auditors, because a high degree of management judgment and subjectivity may present risks of material misstatement, thereby increasing the audit risk (SAS No.99, 2002). Intensive scrutiny by auditors, in turn, reduces the effect of subjective management judgment, thereby enhancing the quality of financial reporting. Therefore, it is an interesting research question to determine whether the valuation effect of OCI between Big 4 and non-Big 4 clients is contingent upon the amount of subjectivity in professional judgment over estimates of OCI measures.

In this study, we empirically examine whether differences in audit quality are reflected in the pricing of OCI. Specifically, we first investigate whether OCI items for Big 4 clients have incremental information content in explaining stock returns compared to those of non-Big 4 clients. The basic premise of this study is that audit quality reflects a form of service distinction that the capital market values differently. Given that Big 4 auditors provide higher-quality assurance regarding the credibility of reported earnings (e.g., Khurana & Raman, 2004), we predict that the OCI audited by a Big 4 auditor is more value-relevant than that audited by a non-Big 4 auditor.

Based on the level of subjectivity and degree of management discretion involved in the OCI reporting process, we then explore whether the differential valuation effect of OCI between Big 4 and non-Big 4 clients is stronger for more subjective OCI components compared to a less subjective component (e.g., marketable-securities adjustment). Some OCI components, such as foreign-currency translation and minimum pension-liability adjustments may utilize more subjective estimates than the marketable-securities adjustment (e.g., Dhaliwal et al., 1999) and therefore require more assurance from auditors. When an active market for a security exists, quoted market prices are the best evidence of fair value and should be used as the basis for measurement, because investors and creditors regularly rely on those prices to make their decisions (PCAOB, 2008). The level of management judgment required in establishing the fair value of financial instruments may be minimal when a quoted price in an active market

³ Specifically, some of the more significant high-risk audit areas identified by the PCAOB's report are: (1) fair-value measurements for financial instruments; (2) fair-value measurement for non-financial assets; (3) impairment of goodwill, indefinite-lived intangible assets, and other long-lived assets; and (4) revenue recognition, and others (e.g., valuation of inventory, income taxes).

is available. Thus, we argue that among OCI components, marketable-securities adjustments are less subject to management judgment and assumption than other components of OCI.⁴

Given that perceived audit quality is valued by the capital market, we predict that Big 4 auditors in general provide higher-quality audits with respect to the amount of subjectivity and management judgment in fair-value estimates compared to non-Big 4 auditors, for several reasons. First, Big 4 auditors are more prone to litigation risk than smaller auditors (see Becker, DeFond, Jiambalvo, & Subramanyam, 1998; Dye, 1993; Francis & Wang, 2008; Kim, Chung, & Firth, 2003). Dye (1993) argues that auditors with more wealth at risk from litigation have greater incentive to issue accurate reports. It is also known that Big 4 auditors are more likely to be sued in case of misstatements because of their "deeper pockets" (Kim et al., 2003) and that audit failures produce greater reputation losses, especially for Big 4 auditors, because they possess greater reputational capital (Becker et al., 1998). Second, Big 4 firms mitigate information asymmetry more than non-Big 4 auditors. Prior studies (Francis, Maydew, & Sparks, 1999; Willenborg, 1999) document that, by providing higher quality auditing services, Big 4 auditors help reduce information asymmetry between shareholders and managers. Khurana and Raman (2004) provide empirical evidence that the cost of equity capital is lower for Big 4 clients than for non-Big 4 clients. Third, large accounting firms are subject to a regular annual inspection by the PCAOB (see PCAOB inspection rule 4003). Although four second-tier audit firms (see 2010 PCAOB inspection report) are also inspected annually by the PCAOB, Big 4 firms are more likely to be subject to the inspection than non-Big 4 auditors, including the second-tier firms, because Big 4 audit firms have far more issuer clients than second-tier firms and a higher number of issuers inspected.⁵ Closer monitoring by the PCAOB induces large auditors to increase their audit effort and make more conservative decisions in their audit engagements. That is, large auditors are likely to be more diligent and watchful (e.g., DeFond, 2010). Fourth, Big 4 auditors have a greater ability to constrain questionable accounting decisions, because they in general have better audit technology, superior knowledge, and a strong negotiation stance with clients in terms of financial-statement requirements (DeFond & Jiambalvo, 1993; Francis et al., 1999).⁶ Finally, the market values a perceived difference in audit quality between Big 4 and non-Big 4 (Knechel, Naiker, & Pacheco, 2007; Menon & Williams, 1991; Palmrose, 1988; Teoh & Wong, 1993; Watts & Zimmerman, 1986).

We partition OCI components into two groups based on the degree of subjective judgment: (1) a less subjective component—the change in unrealized gains and losses on available-for-sale marketable securities (ΔSEC), and (2) more subjective components—the sum of other OCI components, such as change in pension or other postretirement benefits (ΔPEN), change in adjustments for foreign currency translation (ΔFOR), and change in adjustments for derivative instruments that are designated as cash-flow hedges (ΔDER).⁷ Following prior research (e.g., Becker et al., 1998; Craswell, Francis, & Taylor, 1995; DeAngelo, 1981; Khurana & Raman, 2004), we rely on auditor type (i.e., Big N) as

⁴ Not all available-for-sale securities are classified as level 1 estimates. Some of such financial instruments can be grouped as level 2 or level 3. This is even more severe for financial institutions, because available-for-sale securities are often classified as level 1, level 2, or level 3 estimates. In this study, we exclude financial institutions from our sample to mitigate such a potential impact. We thank an anonymous reviewer for this insight.

⁵ Church and Shefchik (2012) report that, in 2009 client portfolios, Big 4 firms have many more issuer clients (6648) than second-tier firms (1432), and 267 issuers of Big 4 audit firms (compared to 104 issuers of the second-tier audit firms) are inspected in 2009.

⁶ DeFond and Jiambalvo (1993) find that Big 8 (now Big 4) auditors are more likely to oppose questionable accounting methods that increase reported earnings.

⁷ We also examine each component of OCI separately and show the results. Details are discussed in a later section.

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