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The Effect of Corporate Governance Mechanism on Comprehensive Income Reporting: A Proposed Model

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Abstract
International Accounting Standard Board (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. When an active market (quoted prices) for other comprehensive income items does not exist, valuation techniques that employ observable or unobservable input are used. Valuation techniques use in determining unobservable input and perhaps observable input requires management assumptions and judgments. Users' concerns about managerial discretions in establishing fair value gains and losses on certain assets and liabilities relating to comprehensive income may pose questionable reliability that subsequently affect investors' pricing of fair value gains and losses reported as dirty surplus flows. On the assumption of valuation theory and agency theory, this paper offers a theoretical explanation on the implication of corporate governance mechanisms (ameliorate reliability issues) on investors' pricing of comprehensive income and other comprehensive income.

Keywords: Auditor's Reputation; Audit Committee Effectiveness; Comprehensive Income; Managerial Discretion.
JEL Classification: G34, M42

1. Introduction

An old and unresolved challenge facing standards setter and users of accounting information centre on the choice of more appropriate method of assessing the periodic financial position and performance (Kanagaretnam, Mathieu & Shehata, 2009). The proponents of all inclusive approach contend that all changes in the value of assets and liabilities measured at the market value should pass through the income statement. Such approach of measuring periodic performance is considered more appropriate because it explicitly shows all changes in the value of assets and liabilities at the beginning and at the end of the financial period (Firescu, 2015). Thus, presenting all cash flows changes resulting for both fair value changes in balance sheet items and cash flows from operating performance, users of financial statement can easily distinguish between value creation and value distribution (Chambers, Linsmeier, Shakespeare, & Sougiannis, 2007; Kanagaretnam et al., 2009; Mechelli & Cimini, 2014; Firescu, 2015). This is contrary to the current operating performance approach where temporary changes (dirty surplus flows) arising from non-core operations bypass the income statement and reported directly on the balance sheet under the owners' equity section[1]. To justify the desirability of all inclusive income approach such as Comprehensive Income (CI), it was argued that reporting dirty surplus flow directly to balance sheet "may encourage management to opportunistically manage earnings. This may cause misleading inferences to be drawn by the users of accounting information" (Kanagaretnam et al., 2009). Therefore, considering the comprehensiveness of all inclusive approach of measuring financial performance, promoters call for a CI-type statement to display all relevant components of income (Hirst & Hopkins, 1998; Kanagaretnam et al., 2009; Lee & Park, 2013; Firescu, 2015).

Interestingly, the propositions by the promoter of all inclusive measurement method, partly stimulate the enforcement of Statement of Financial Accounting Standard (SFAS 130) and International Accounting Standard (IAS 1) on CI reporting (Kanagaretnam et al., 2009; Lee & Park, 2013; Mechelli & Cimini, 2014). By these promulgations, companies are mandated to mark-to-market changes in the value of non-current assets, available-for-sale financial assets, foreign currency translation from foreign operations, defined benefit plans and effective portion of cash flow hedge (Kanagaretnam et al., 2009; Lee & Park, 2013; Firescu, 2015). The visibility of these Other Comprehensive Income (OCI) items on the face of primary financial statements will probably lessen the cost of searching for important valuation matric (Hirst & Hopkins, 19981; Kanagaretnam et al., 2009; Lee & Park, 2013), reduce earnings management (Song, Thomas, & Yi, 2010; Lee & Park, 2013) and reduce the propensity of losing vital information (Hirst & Hopkins, 19981; Song et al., 2010). Thus, their presentation provides capital markets participants with multiple relevant financial performance indicators and consequently enhances the level of transparency of financial statements. As a follow-up on this argument, numerous studies had established that these dirty surplus flows represent relevant information to investors (Song et al., 2010; Kanagaretnam et al., 2009; Smith & Jones, 2011; Lee & Park, 2013).

However, evidence abounds that fair value measurement induced earnings management, especially for measurement method that requires judgements and assumptions (Dhaliwal et al. 1999; O'Hanlon & Pope, 1999; Lopes & Walker, 2012). Given that CI and OCI comprises of several items with varied fair value measurement levels, including unobservable inputs and perhaps observable inputs, intrinsic estimation error and management-induced error may exist. The impending concern for this possibility is the

[1] This position is assumed because allowing these less persistent 'dirty surplus" to pass through the income statement increases earnings volatility and reduce its importance for valuation and contracting purpose (Kanagaretnam et al., 2009; Lee & Park, 2013). Another major criticism against current operating performance is the arbitrary manner in which substantial accounting amount eludes disclosure on the face of the primary financial statement (Cahan, Courtenay, Gronewoller, & Upton, 2000; Kanagaretnam et al., 2009; Lee & Park, 2013).

questionable reliability of fair value gains and losses on OCI items used in computation of CI and OCI. This is because unlike using quoted price to determine fair value of assets or liabilities, valuation techniques applicable for observable and unobservable inputs require management to make some judgments and assumptions (Song et al., 2010; Lee & Park, 2013). Given the propensity of measurement errors and perhaps intentional manipulation when using discretion to determine these fair value gains and losses, investors could expect deviations on the part of the managers (Song et al., 2010; Lee & Park, 2013). This may indicate some information asymmetry problems capable of creating severe moral hazard (Bartov, Mohanram, & Nissim, 2007; Song et al., 2010; Lee & Park, 2013).

Seemingly, these anomaly are often curtailed through effective corporate governance practices serving as a deterrent to unethical behaviour (Bartov et al., 2007; Song et al., 2010; Lee & Park, 2013). This is based on a general perception that corporate monitoring curtail opportunistic tendencies and hence, enhances the reliability and integrity of the financial reporting process (Song et al., 2010; Lee & Park, 2013). Thus, in valuing CI and OCI, investors may place different weights on these earnings numbers based on firms' corporate governance mechanisms as Habib and Azim (2008), Song et al. (2010), Lopes and Walker (2012), Lee and Park (2013) documented for other accounting numbers. In this study, we provide a theoretical explanation on how corporate governance mechanisms could ameliorate investors' perception of the reliability of CI and OCI. Specifically, we demonstrate how audit committee independence, audit committee financial expertise, the frequency of audit committee meetings, audit committee size, no internal control material weakness and auditor's reputation would enhance the value relevance of CI and OCI. These corporate governance variables are synonymous with six CG elements.

The remaining part of this paper is structured as follows: section two presents related literature on CI and OCI. Section three delineates review of corporate governance variables. We discussed the theoretical framework in section four and section five is the conclusion.

2. Literature Review

2.1 Related Literature on Comprehensive Income and Other Comprehensive Income

One primary objective of preparing and publishing a financial statement is to provide useful information on the financial position and performance of a business. Accounting earnings is one of several important information published in the financial statement that give an insight about the real performance of a firm to users (Subramamyam, 2014). Accounting earnings is a multifaceted variable used to describe a firm's income, such as CI and OCI. IAS 1 " Financial Statement Presentation", define CI is the net income adjusted for OCI items, whereas OCI is the sum of:

1. Changes in revaluation surplus for Property, Plant and Equipment (IAS 16);
2. Actuarial gains and losses on defined benefit plans recognised in accordance with paragraph 93 of IAS 19 Employee Benefits;
3. Changes in foreign currency from translating the financial statements of a foreign operation (IAS 21 the Effects of Changes in Foreign Exchange Rates); and
4. Gains and losses on re-measuring available-for-sale financial assets (IAS 39 Financial Instruments: Recognition and Measurement).

One major innovation by the IASB is mandating the presentation of CI and OCI in financial statements when reporting under IAS/IFRS regulation. A plausible justification for this is to enhance the transparency of financial statements and simultaneously provide capital market's participants with more financial performance indicator for firm valuation. A tremendous effort had been made in examining the relative and incremental value relevance of CI and OCI. On the wave of this interest, Cheng et al. (1993) revealed that when explaining the market value of equities, net income dominates CI. Dhaliwal et al. (1999) and O'Hanlon and Pope (1999) found no evidence to conclude that CI was more strongly priced than the traditional net income. Similar to the pioneering studies, more recent studies found evidence to support a dominance of net income over the CI (Wang, Buijink, & Eken, 2006; Brimble & Hodgson, 2008; Goncharov & Hodgson, 2011; Jones & Smith, 2011; Turen & Hussiny, 2012; Mechellia & Cimini, 2014; Firescu, 2015; Marchinia & D'Este, 2015). By contrast, some authors have also reported opposite result, suggesting dominance of CI over the traditional net income (Cahan et al., 2000; Biddle & Choi, 2006).

Another line of research investigates the incremental value relevance of OCI. Using samples of New Zealand firms, Cahan et al. (2000) revealed that OCI provides incremental information over traditional net income. However, they established that no benefit exists for reporting a separate CI type statement. O'Hanlon and Pope (1999) and Dhaliwal et al. (1999) documented that OCI scaled by the beginning price and stock returns was value destroying in the United Kingdom and the United States respectively. According to Wang et al. (2006) and Kanagaretnam et al. (2009), accumulated dirty surplus flows for a period of 10 years and yearly OCI were not value relevant. In some instance, OCI was value relevant, but displayed a negative persistence (Jones & Smith, 2011), continuously lower than that of traditional net income (Mechelli & Cimini, 2014), and was driven by the "expected location based on the firm's reporting history" (Schaberl & Victoravich, 2015, p. 6).

Overall, commenting on the above review, it is safe to postulate that consensus has not been reached on the superiority of CI over the net income (historical cost convention). Also, the incremental value relevance of OCI is driven by contextual factors. Again, how subjectivity in measuring some OCI items affects the overall value relevance of CI and OCI is less clear from the previous studies. Exceptions are O'Hanlon and Pope (1999), Lopes and Walker (2012) and Lee and Park (2013). O'Hanlon and Pope (1999) claimed that, contrary to the general perception of increased clarity and transparency of CI reporting does not translate to incremental value relevance of earnings, but seems to reduce undesirable creative accounting activity by UK firms" (p. 1). Lopes and Walker (2012) documented that fair value measurement of OCI items is associated with agency cost because it was designed to improve equity positions and not to signal additional information to investors. Lee and Park (2013) claimed that more subjective components of OCI were more value relevant when conditioned for auditor's reputation. Building on these studies, the current study proposes a model that incorporates six CG elements to demonstrate the effect of overall corporate governance mechanism on investors' pricing of CI and OCI as discussed in the next section.

3. Review of Corporate Governance Variables

Historically, corporate governance practices or codes were designed in developed countries (Reed, 2002). However, developing countries have found it essential to mimic developed countries in order to attract capital inflows and to enhance capital market operations (Reed, 2002). One pivotal function of corporate governance that is well ingrained in the literature is its oversight function intended to protect the quality of financial statement to safeguard the interests of various stakeholders through (Habib & Azim, 2008; Bhat, 2009; Song et al., 2010; Lopes & Walker, 2012; Lee & Park, 2013). Given its benefits, firms are under pressure to adopt good corporate governance, which is often formalized in terms of corporate governance codes.

Because the present accounting environment tilted towards fair value accounting reinforces the need for effective corporate governance practices to maintain public trust on the quality of accounting information. In Figure 1, we argued that high corporate governance practices could lead to positive behavioural attitude and mitigate agency cost and subsequently lead to high quality accounting numbers. This is because both internal and external audit functions perform several audit tasks, which overall, strengthen the operational environment and ensure transparent financial reporting process. For reasons presented beyond this paragraph, we propose that elements of corporate governance mechanisms comprising of internal and external audit function could influence investors pricing of CI and OCI.

A general assumption entails that involvement of external auditor in the financial reporting process enhances the quality of financial statement (Ismail & Chandler, 2005; DeFond, 2010; Song et al., 2010; Lee & Park, 2013). While reducing agency cost of opportunistic behaviour of managers, external auditor provides a third party opinion on the reliability with which client's financial statement is drawn. Presumably, external auditors provide higher-quality audit, which reduces the amount of management subjectivity of questionable accounting decisions (Song et al., 2010; Lee & Park, 2013) and need to avert litigation risk (Lee & Park, 2013). Because CI and OCI items comprise of "mark-to-market" types of adjustments, investors may be constrained from observing directly whether the reported information reflected the real firm's financial performance. Often, they rely on the auditor's judgement of the fair-value measurement of such economic assets and liabilities (Song et al., 2010; Lee & Park, 2013). Thus, it is possible to notice a superior level relationship of CI and OCI and the market value of equities for reputable audit firms. DeFond (2010), Song et al. (2010) and Lee and Park (2013) examined the effect of auditor's reputation on investors' pricing of OCI items and fair value hierarchy information using return model. An interesting finding from their study suggests higher investors' pricing of OCI items and fair value hierarchy information when financial statement is certified by reputable auditors. Thus, the impact of the auditor's reputation on the investors' judgment of reliability of CI and OCI is justified.

Similarly, audit committee effectiveness is one of the components of corporate governance element frequently associated with the quality and integrity of financial reporting. Internationally, a best practice audit committee has been emphasised 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 part of the corporate governance oversight function, an effective audit committee has a discipline effect on the management's discretion in the fair value determination (Song et al., 2010). Reporting entities with no audit committee are more likely to engage in financial statement fraud and other accounting irregularities (Abbott & Parker, 2000; Abbott, Parker, & Peters, 2004).

For instance, the proportion of independent non-executive directors to the total number of directors sitting on the boards was positively associated with comprehensiveness of financial disclosure (Chen & Jaggi, 2000), negatively associated with earnings management (Klein, 2002; Jenkins, 2003) and more reliable reported earnings (Woidtke & Yeh, 2013). The independence of audit committee significantly associated with firm performance, especially for firms with high agency conflicts (Dey, 2008). By contrast, Rainsbury et al. (2009) and Suárez et al. (2013) documented that the quality of accounting numbers is not associated with the proportion of audit committee independent directors. Studies that observed enhanced quality of financial reporting claim that independent director's financial sophistication could be important factors in reducing earnings management. This could imply more human resources for effective scrutiny of subjective accounting measures and related valuation models (Xie, Davidson & DaDalt, 2003). Thus, high quality CI and OCI can be expected for firms with high number of independent directors as audit committee members.

Audit committee meeting is another corporate governance element frequently associated with quality of earnings. The frequency of audit committee meetings allows the committee members an ample time to review the internal control system and firms overall audit process to ensure financial reporting quality (Xie et al., 2003; Barua et al., 2010; Yasin & Nelson, 2012; Woidtke & Yeh, 2013). The frequency of audit committee meetings is negatively associated with discretionary current accruals (Xie et al., 2003) and more likely to update the members on the current auditing issues and be more diligent in fulfilling their duties (Yasin & Nelson, 2012).

Furthermore, the presence of a financial and auditing expert sitting in the audit committee quorum leads to high quality financial statements. The financial expertise of audit committee members seems to be a fundamental factor in monitoring and forestalling earnings management and financial restatement (Xie et al., 2003; Agrawal & Chadha, 2005). Evidence of positive stock market reactions as a response to good news management forecasts for firms with financial and audit expertise on their audit committee has been documented (Davidson et al., 2004; DeFond et al., 2005; Karamanou & Vafeas, 2005; Woidtke & Yeh, 2013). Audit committee members with financial expertise make useful input that aids the committee at reducing internal control problems and inefficiency in financial reporting (Xie et al., 2003; Naiker & Sharma, 2009; Rainsbury et al., 2009; Yasin & Nelson, 2012). Thus, the above evidence suggests that audit committee financial expertise can improve financial reporting quality by reducing incidences of earnings management, accounting irregularities and fraudulent financial reporting. Thus, market participants may perceive CI and OCI by these firms to be more value relevant and reliable.

Also, previous studies provide links between internal control system and the quality of accounting information. For instance, the determinants of disclosure of material weaknesses in internal control (Doyle, Ge, & McVay, 2007a), effect of material weaknesses and earnings quality (Doyle, Ge, & McVay, 2007b; Ashbaugh-Skaife, Collins, Kinney, & LaFond, 2008), corporate disclosure behavior (Gordon, Loeb, Lucyshyn, & Sohail, 2006), and reactions of market participants to the disclosure of internal control weakness (Hammersley, Myers, & Shakespeare, 2008; Kim & Park, 2009; Brown et al., 2014). Firms without material internal control weakness problems are less likely to suffer aggressive financial reporting, estimation errors and biased management forecasts. One possible reason for this is that effective internal control system allows the internal audit staff to monitor preparation of the annual report effectively (Song et al., 2010). Thus, if an assumption is made based on previous findings that an internal control system reduces the reliability concern of fair value estimate, then it can be argued that disclosure of no material internal control weakness may enhance investors' pricing of CI and OCI.

Based on the above review, the influence of corporate governance elements on the quality of financial statement is unequivocally presented. Therefore, to the extent that corporate governance mechanism measured based on the six CG elements will scrutinize the financial reporting process, opportunistic assumption and judgement in the financial reporting process will reduce. To the extent that the perceived reduction in agency cost would ameliorate the reliability concern of professional and non-professional investors, one might expect that the strength of corporate governance could influence investors pricing of CI and OCI as presented in Figure 1.

3. Theoretical Framework

One important theory that we used to demonstrate the relationship between CI and OCI and market value of equities is the valuation theory (Beaver, 2002). To provide alternative valuation metric to capital markets participants beyond the traditional net income, both FASB and IASB require gains and losses from non-core business activities to be included in financial statement as OCI items when determining CI for a given period. This approach suggests adjusting net income for OCI items as defined by the IAS 1. Even though OCI items are market based measures, their presentation in the primary financial statement to display all changes in the economic value of assets and liabilities at the beginning and at the end of the financial period is perceived as the most appropriate approach to income measurement for firm valuation (Chambers et al., 2007; Firescu, 2015).

On the basis of the valuation theory, several studies had documented relative and incremental value relevance of CI and OCI. Using valuation as a paradigm, prior studies estimate the coefficients of net income and CI with share price or stock returns in separate models to test their importance for valuation input (Dhaliwal et al., 1999; O'Hanlon & Pope, 1999; Cahan et al., 2000; Goncharov & Hodgson, 2011; Jones & Smith, 2011; Turen & Hussiny, 2012; Mechellia & Cimini, 2014; Firescu, 2015; Marchinia & D'Este, 2015). A variable and model with higher coefficient and adjusted R^2 is considered to be the most value-relevant. Another stream of literature also investigates the incremental value relevance of OCI (O'Hanlon & Pope, 1999; Biddle & Choi, 2006; Wang et al., 2006; Jones & Smith, 2011; Mechellia & Cimini, 2014; Schaberl & Victoravich, 2015). These studies are based on the assumption that OCI is value relevant when compared to the net income if its regression coefficient is significantly different from zero. Overall, these studies affirmed that both CI and OCI represent a significant predictor of the market value of equities. Therefore, our choice of the valuation theory to demonstrate direct test of the relationship between CI and OCI and the market value of equities is justified.

As discussed in the previous section, there exist instances where investors could exhibit defalcation when valuing CI and OCI due to the use of valuation technique (for observable and unobservable input) to determine economic value of assets and liabilities whose input are not obtainable from the active market. If the perception of investors about the financial statements quality favours assumptions of a usual "big bath" instead of genuine changes, it is possible not to identify relative and incremental value relevance of CI and OCI respectively. But, because firms will want to be recognised for best practices, we employed agency theory to demonstrate how corporate governance mechanisms influence investors valuation of CI and OCI due to reduction in perceived information asymmetry.

In an incomplete and imperfect market condition, agency cost appears as a common threat that fraught the principal-agent relationship (Jensen 1976, Lee & Park, 2013). Because agents have a high level of control of firm's operations and task with the responsibility of preparing financial statement, they may explore the advantage of being more informed than investors and misrepresent information for personal benefits (Dey, 2008). Under such condition, agency cost is likely to be severe where there is an absence of the market value of certain assets and liabilities, but rather measured using internally generated estimates (mark-to-model). When fair value estimates are mark to model, it would be difficult for investors to verify the true and fair view of such transactions (Song et al., 2010; Lee & Park, 2013). Given the fact that interest of the principal may not always be the motive of the agent, it is not exaggeration to say actual results could differ materially from the reported information (Dey, 2008; Song et al., 2010; Lee & Park, 2013). Managers may elect valuation technique that is technically within accounting standard, but compromise representational faithfulness. For instance, the desire to achieve certain performance target may motivate managers to smooth earnings instead of reporting volatile earnings or understate/overstate values of assets and liabilities. This scenario presents cases of information asymmetry and deterioration in capital market efficiency (Dey, 2008; Francis & Michas, 2013; Woidtke & Yeh, 2013).

However, a measurement approach that uses valuation techniques should probably suffer less information asymmetry, given firms strong corporate governance mechanisms. This is because anecdotal and empirical evidence underscores the importance of corporate governance mechanism on reliability of accounting information (Bartov et al., 2007; Dey, 2008; Habib & Azim, 2008; Song et al., 2010). Specifically, an interplay of audit committee effectiveness, sound internal control system and external auditor's reputation could substantially shape the quality and integrity of reported accounting numbers (Ismail & Chandler, 2005; Dey, 2008; Song et al., 2010; Francis & Michas, 2013; Woidtke & Yeh, 2013). While performing a monitoring role, the knowledge, expertise and different skills possessed and exchanged between these corporate governance elements could mitigate agency costs induced by information asymmetries. Therefore, we propose that the corporate governance mechanism is likely to enhance the perception of investors about the reliability of CI and OCI.

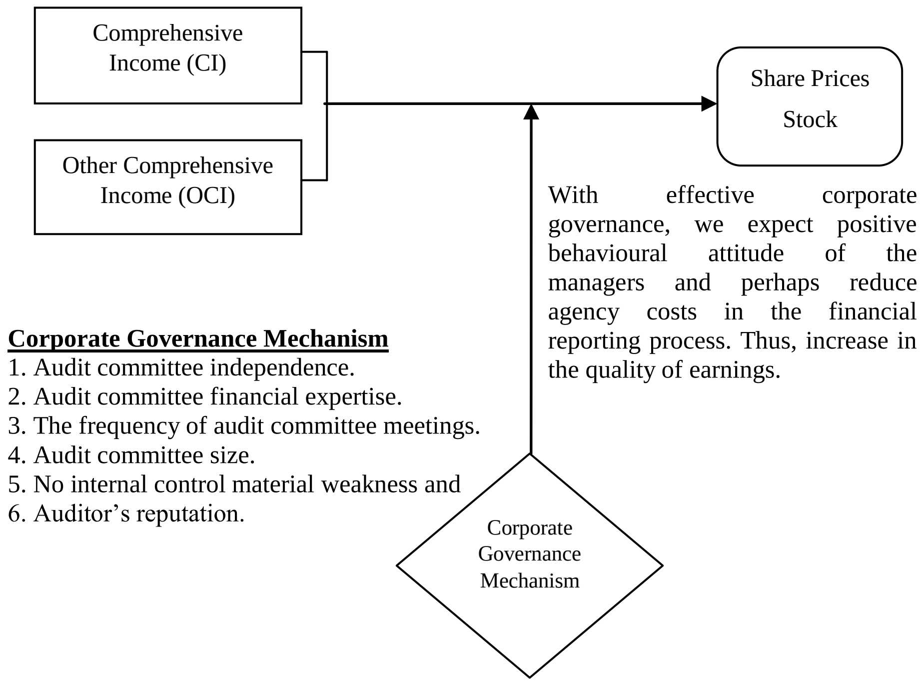

Figure 1: Conceptual Framework on the Influence of Corporate Governance Mechaniss on the Relationship Between Comprehensive Income and Other Comprehensive Income and Share Prices/Returns.
Note: We propose that a combined score and individual elements would address the reliability concern regarding management's judgement and assumptions relating to CI and OCI.

4. Conclusion

This study is motivated by the managerial subjectivity in the fair value determination of certain assets and liability as they relate to comprehensive income and other comprehensive income measure of financial performance. Evidence from previous studies suggest that regardless of measurement approach used in ascertaining holding gains and losses on certain financial assets and liabilities, comprehensive income and other comprehensive income represent important financial performance indicators. Unequivocally, previous studies had also established the influence of a sound internal control system, audit committee effectiveness and external auditor's involvement on the quality and reliability of financial information. We proposed the influence of these variables on the value relevance of CI and OCI. Consequently, providing scholarly evidence on the combined and individual influence of corporate governance variables on comprehensive income and other comprehensive income could extend the value relevance and corporate governance literature.

This shift in methodology had several critical implications for improving firms' valuation. First, if the proposed framework is validated, the findings would provide useful insight to investors and managers on the importance of combining financial and non-financial information in the valuation process. Second, we believe that this approach will help to minimize the bias risk of value relevance inference, especially in environment where doubt has been raised over accounting and auditing practice and could be a long lasting panacea to rebuilding investors' confidence on accounting numbers. Our inability to comprehensively discuss a wider spectrum of corporate governance variables is the major caveat of this paper.

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