Chapter 4
The Auditor as a Determining Factor on Derivative Financial Instrument Disclosures

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ABSTRACT

Based on the premise that the quality of the audit is related to the quality of the financial reporting, the purpose of this chapter is to verify if the audit is a determining factor in derivative financial instruments disclosures. However, the academic literature has revealed that audit quality is influenced by a number of factors, such as gender, experience, and auditor's fees, as well as the type of audit firm (Big4 or not Big4). In order to achieve the proposed objective, a disclosure index was prepared, based on the requirements of the International Accounting Standards Board (IASB), applied to companies listed on Euronext Lisbon, excluding the sports corporations. The results revealed that the level of disclosure is influenced by the size of the audited company and by the auditor's gender, being greater in the larger companies and in the companies audited by a male auditor.

INTRODUCTION

The disclosure of information about derivative transactions and risks incurred in contracting these instruments has been the subject of some debate at an international level. These instruments are associated with financial disasters and their complexity has raised worries among stakeholders, who are eager to understand how companies operate in derivatives markets and the associated risks. Given the above, the accounting standard bodies have tried to improve the quality of information disclosed, in order to ensure comparability at national and international levels.

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According to Rijwani and Rajpurohit (2017), the audit has an important role in the financial reporting process because it provides assurance about its credibility. A study by Nwanyanwu (2017) revealed a statistically significant positive and strong relationship between audit quality and financial reporting. According to this author, audit practices aim to ensure that financial statements reveal relevant and reliable information to members of an organization and to the public. According to Baffa (2017), the role of an audit is to improve the quality of financial statements, since quality reporting reduces the problems of information asymmetry. Similarly, the studies of Ogundana, Ojeka, Ojua and Nwaze (2017), Gebrayel, Jarrar, Salloum and Lefebvre (2018), and Tambingon, Yadiati and Kewo (2018) revealed that the audit – in these cases, internal – has a significant effect on the quality of financial information on risk assessment.

According to Fukukawa and Kim (2017), because auditors are concerned about the quality of their audit, they try to influence disclosure practices. Because the management body has a discretionary power over the disclosure of financial information, auditors can obtain a competitive advantage by providing useful advice to the management body regarding the information to be disclosed, and the extent and type of disclosure that is appropriate. Also, Barako, Hancock and Izan (2006) argue that while it is the responsibility of the management body to prepare the financial report, an auditor can significantly influence the amount of information disclosed.

Regardless of whether it is an internal or external audit, it is undeniable the role of this supervisory mechanism on the quality of financial information. Based on this premise and the assumptions of agency theory, it is assumed that the external audit – called a statutory audit when imposed by law or auditing the accounts when exercised voluntarily in Portugal – will be a determining factor in the disclosure of financial derivative instruments. Moreover, Peters, Abbott and Parker (2001) argue that the quality of the auditor may be negatively associated with the level of disclosure because firms can legitimize themselves by compensating for the disclosure of reduced information through auditor quality. According to agency theory, managers are incentivized to hire quality auditors in order to make their disclosures credible and avoid the costs of non-disclosure (Peters et al., 2001). These authors obtained empirical evidence of a negative association between the level of voluntary disclosure about commodity derivatives and the level of expertise of the auditor.

Based on this premise and the assumptions of agency theory, it is assumed that auditing will be a determining factor in the disclosure of derivative instruments. However, the academic literature has revealed that the audit process and its consequent quality can be influenced by numerous factors, such as gender and professional experience of the auditor, as well as the fees received by the audit service and even the type of firm where the auditor carries out their function (Big 4 or not Big 4). Therefore, the purpose of this study is to verify if the auditor is a determining factor in derivative financial instrument disclosures.

This research has an innovative character because, although there are studies about the determinants of derivative instrument disclosures, there is no study that analyses in isolation the influence of the auditor in the level of disclosure.

The next section of this chapter sets out the background to our research. Subsequently, the hypotheses of the investigation are defined. The remaining sections describe the research design and method, and report the content analysis results. Finally, we present solutions and recommendations, future research directions, and the main conclusions.