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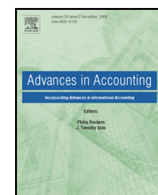

Reporting location and the value relevance of accounting information: The case of other comprehensive income

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ABSTRACT

This paper examines the influence of reporting location on the value relevance of other comprehensive income (OCI). Accounting Standards Update (ASU) 2011-05 "*Presentation of Comprehensive Income*" requires firms to report OCI in a performance statement (i.e., either below net income in a single statement of comprehensive income or in a second statement of comprehensive income that begins with net income). ASU 2011-05 eliminated the option of reporting OCI in the statement of equity, based on the argument that performance reporting would improve the transparency of OCI in the financial statements. We find mixed evidence that the value relevance of OCI differs across management's choices of OCI reporting location prior to the implementation of ASU 2011-05. However, we do find a decline in the value relevance of OCI for firms that were *required to change* the reporting location of OCI from the statement of equity to a performance statement in response to ASU 2011-05. This result holds after we include a control group consisting of firms that did not change the reporting location of OCI. Overall, our findings suggest that the value relevance of OCI is determined by whether its reporting location is consistent with the firm's reporting history.

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1. Introduction

In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2011-05 "*Presentation of Comprehensive Income*". The objective of this Update is to "[…] improve the comparability, consistency, and transparency of financial reporting and to increase the prominence of items reported in other comprehensive income […]" (ASU 2011-05, p. 1). Under Statement of Financial Reporting Standard (SFAS) 130 "*Reporting Comprehensive Income*", firms could choose to report the components of other comprehensive income (OCI) in the statement of equity or in a performance statement. ASU 2011-05 eliminated the option of reporting OCI only in the statement of equity in lieu of requiring OCI to be reported in a performance statement. A performance statement can take one of the following two formats: a single statement of comprehensive income with the components of OCI below the components of net income (single-statement option); or a second separate statement of comprehensive income (two-statement format) that begins with total net income.

Based on the initial 1996 FASB exposure draft regarding performance reporting for other comprehensive income (FASB, 1996), Yen, Hirst, and Hopkins (2007) conducted a content analysis of the comment letters which indicated that the overall tenor of comment letters was in opposition to the proposed change. This finding suggests that respondents (i.e., reporting firms, major public accounting firms and professional organizations) also believe that reporting location matters despite the fact that ASU 2011-05 (as implemented) does not change what items have to be included in OCI. This Update only affects firms' options for OCI reporting *location*. That is, the values of comprehensive income, net income, and OCI are not affected, and as a result there is no impact on items such as debt covenant compliance and management compensation. Nevertheless, current research provides convincing evidence that standard setters, investors, and managers believe that the reporting location of OCI influences its usefulness to investors (Black, 2014).

Further, many comment letters indicated that respondents had a preference for the two-statement option over the one statement option due to the concern that reporting net income and OCI as two subtotals in a single statement of comprehensive income would "inappropriately deemphasize net income, causing confusion in the capital markets" (ASU 2011-05, BC8). Several respondents indicated a belief that the proposed change would impact investors' perceptions of their firm's operating results and risk level. On the other hand, a recent study conducted by the Certified Financial Analysts (CFA) Institute argues that OCI

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information is underutilized by investors and suggests that investors should increase their use of this information when making valuation decisions. As a result, the CFA proposes to enhance the presentation of OCI items by financial statement preparers and standard setters (Papa, Peters, Schacht, & Lu, 2015).[3]

Prior evidence suggests that management believes that the reporting location of OCI influences its usefulness. Lee, Petroni, and Shen (2006) provide archival evidence based on firms in the property-liability insurance industry in which a relatively large percentage of firms chose to report OCI in a performance statement instead of the statement of shareholder's equity. They find that managers who manage earnings through sales of AFS securities and firms with low disclosure quality are more likely to report the components of OCI in the statement of shareholder's equity.

The purpose of this study is two-fold. First, it aims to provide additional insight as to whether the financial statement reporting location of OCI matters to investors as evidenced by differences in the value relevance of OCI.[4] Second, it examines whether mandatory performance reporting is more value relevant than the more frequently used equity statement reporting prior to ASU 2011-05. In addition to the comment letters that suggest there is a *perceived* importance of reporting location, Rees and Shane (2012) note that whether the reporting location of OCI is of *actual* importance to capital market participants remains an unanswered question due to mixed findings across experimental studies (Hirst & Hopkins, 1998; Maines & McDaniel, 2000) and archival studies (Chambers, Linsmeier, Shakespeare, & Sougiannis, 2007). Given the recent implementation of ASU 2011-05, this study is not only timely but speaks directly to the usefulness of the mandated reporting location change of OCI and thus should be of interest to standard setters.

Research examining firm's OCI reporting choices suggests a *perceived* importance of OCI reporting location. Prior to the implementation of ASU 2011-05, a majority of firms chose to report OCI in the statement of equity (e.g., Bamber, Jiang, Petroni, & Wang, 2010; Chambers et al., 2007). In our sample, 65% of firms report OCI *only* in the statement of equity *before* the implementation of ASU 2011-05. Approximately 83% (85%) of firms that report OCI in a performance statement use the two-performance statement option in the pre-ASU (post-ASU) period. Consequently, the implementation of this update required numerous firms to change the reporting location of OCI from the previous location in the statement of equity. Consistent with comment letters, the finding that a majority of firms chose not to report OCI and net income in one statement suggests that firms are concerned about the possibility of investors confusing the two amounts.[5]

For the first setting, the pre-ASU period — when management was still able to *choose* the reporting location of OCI — we find mixed evidence that the value relevance of OCI differs across management's choice of OCI reporting location, with OCI being the most value relevant when reported in the statement of equity. This finding is contrary to the FASB's expectation and prior experimental evidence which suggests that performance reporting leads to more transparency and therefore higher value relevance. Our results are largely consistent with the findings presented by Chambers et al. (2007) who find that OCI is more value relevant when reported in the predominant reporting location during the sample period, (i.e., the statement of equity).[6]

For the second setting, the pre/post-ASU period, we find that the implementation of ASU 2011-05 led to a decrease in the value relevance of OCI for those firms which *changed* the reporting location of OCI from the statement of equity in the pre-ASU period to a performance statement in the post-ASU period. This result holds after we include a "control group" consisting of firms that did not change the OCI reporting location between the pre-ASU and post-ASU period.

Overall, our results suggest that although reporting OCI components in a performance statement might be perceived as the more transparent and therefore preferable approach, a mandated change in reporting location to a performance statement had an adverse impact on the value relevance of OCI. Together with prior evidence, our findings indicate that the value relevance of OCI is higher when a firm's reporting location of OCI is consistent with its reporting history.

2. Background and hypotheses

According to the traditional Efficient Markets Hypothesis (EMH), the reporting location of financial information should not impact its value relevance (Malkiel & Fama, 1970). However, the debate on the reporting location of OCI has continued for decades. This debate has continued due to conflicting viewpoints by academics, reporting firms and standard setters. Those against performance reporting argue that it is unnecessary because OCI is not value relevant given that the underlying components are transitory in nature. Supporting this view that OCI is transitory and thus less value relevant, several studies using samples of US firms report that net income outperforms OCI in predicting future cash flows and has a greater association with market value (Cheng, Cheung, & Gopalakrishnan, 1993; Dhaliwal, Subramanyam, & Trezevant, 1999; Choi, Das, & Zang, 2007; Barton, Hansen, & Pownall, 2010; Zülch & Pronobis, 2010).[7] While OCI might be transitory, these studies also suggest that total OCI is in fact priced by the US capital markets.

Further, the value relevance of OCI relative to net income is most likely dependent on the country in which it is investigated. Lin (2006) reports that other comprehensive income items are more value relevant than net income when reported in a combined statement of other comprehensive income and net income based on a sample of UK firms. Lin, Ramond, and Casta (2007) also find that other comprehensive income provides incremental value relevance beyond net income for most of the European Union (EU) firms examined in their sample. These findings suggest the importance of revisiting the OCI reporting location debate after the mandatory reporting requirement in the US.

Another concern by standard setters complimented by academic research is that managers' choice of reporting location of OCI is driven by opportunism and as a result managers may avoid performance reporting to reduce transparency. Lee et al. (2006) find that insurance companies prefer to report unrealized gains and losses on available for sale (AFS) securities which are used to smooth earnings in the statement of equity instead of in a performance statement. Further, Bamber et al. (2010) report that managers are less likely to choose performance reporting when their equity compensation is more sensitive to changes in stock price, job security is lower, and larger (absolute) unrealized gains and losses on AFS securities are reported. These studies

[3] Although the position paper is based on a sample of banks, the recommendations listed in the paper are also applicable to OCI information for non-financial firms.

[4] Consistent with prior studies, we define value relevance of an information item as its ability to capture or summarize any type of information that affects stock prices in the current period (e.g., Lev, 1989; Lev & Zarowin, 1999; Francis & Schipper, 1999; Dhaliwal, Subramanyam, & Trezevant, 1999; Barth, Beaver, & Landsman, 2001; and Chambers et al., 2007 among many others).

[5] For example, the Financial Executives Institute stated, "We recommend that the Board continue to permit optionality in the presentation of Comprehensive Income and allow preparers to choose between a single, continuous statement of Comprehensive Income or a two-statement approach. We believe that a two-statement approach will provide additional prominence to elements of OCI while not diminishing the importance of Net Income to the users of our financial statements." Federated Investors Inc. a major investment manager made a similar comment, "We believe that a continuous statement of comprehensive income would create confusion to the primary users of the financial statements by decreasing the presentation prominence of the key performance measurements, net income and earnings per share." http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821395691&blobheader=application%2Fpdf

[6] In the Chambers et al. (2007) study, the post-SFAS 130 sample (i.e., years 1998–2003) covers 2272 firm-years (~80%) with OCI reporting location in the statement of equity and 535 firm-years (~20%) with OCI reporting location in a performance statement.

[7] Based on a sample of 48 New Zealand firms, Cahan, Courtenay, Gronewoller, & Upton (2000) find that comprehensive income is more value relevant than net income.

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