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Research report

Enhanced disclosure of other comprehensive income and increased usefulness of net income: The implications of Accounting Standards Update 2011–05

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ABSTRACT

Accounting Standards Update (ASU) 2011–05 eliminates the option to present other comprehensive income (OCI) in the statement of changes in stockholders' equity. This study empirically investigates whether this mandatory change of OCI presentation format achieves FASB's stated objective of improving the transparency of financial reporting. First, ASU 2011–05 is found to greatly reduce the continuity of OCI from one period to the next. As OCI items are transitory in nature, the increased OCI volatility makes firms' inherent risk more transparent to investors. Second, ASU 2011–05 is found to significantly increase the ability of net income to influence stock prices. As OCI and net income are intertwined, the more salient presentation of OCI enables investors to better interpret earnings. Supporting FASB's position that OCI items need to be more prominently displayed, these findings suggest that the new standard improves transparency and usefulness of the reported OCI information.

1. Introduction

Comprehensive income, the change of stockholders' equity from non-owner sources in a given period, consists of net income and other comprehensive income (OCI).[1] How to present comprehensive income has been at the center of regulatory attention for the past two decades. In June 1997, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 130 *Reporting Comprehensive Income*, which is now part of Accounting Standards Codification (ASC) Topic 220 *Comprehensive Income*. Consistent with the suggestion by the Association for Investment Management and Research (AIMR, 1993) that a clear display of OCI components in a performance statement would enhance the transparency of financial reporting, the exposure draft of SFAS 130 initially required that OCI and its components be presented in two performance-based alternatives, either in a single continuous statement of income or in a separate statement of comprehensive income (FASB, 1996). Many respondents, mostly financial statement preparers, believed that the location of OCI disclosure could influence investors' judgments (Yen, Hirst, & Hopkins, 2007). However, about 60% of the comment letters sent to the FASB reacted negatively to the proposal, stating that investors would be unable to determine which measure, net income or comprehensive income, was the appropriate one for investment decisions (Du, McEnroe, & Stevens, 2016; FASB, 1997). Relenting to this pressure, the FASB in the final version of SFAS 130 allows a third, non-performance-based option, which is to present OCI in the relatively obscure statement of changes in stockholders' equity (Jordan & Clark, 2014).[2]

The non-performance-based option has become the prevalent format to disclose OCI since the implementation of SFAS 130, because managers believe that the greater volatility of firm performance under the performance-based option could hurt the firm's stock price and thus jeopardize their own careers (Bamber, Jiang, Petroni, & Wang, 2010; Graham, Harvey, & Rajgopal, 2005). In a random sample of 100 NYSE firms, 89 reported OCI in a statement of changes in stockholders' equity, two in a continuous statement with net income, and nine in a separate statement of

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[1] OCI includes net unrealized holding gains and losses on some securities, gains and losses from amendments to postretirement benefit plans, deferred gains and losses on derivatives, and adjustments from foreign currency translation.

[2] On the contrary, IAS 1 *Presentation of Financial Statements* permits an entity to present OCI either in a single statement of comprehensive income or in two separate statements of net income and other comprehensive income (International Accounting Standards Board (IASB), 2007).

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comprehensive income (Pandit & Philips, 2004). Partly because of the widespread avoidance of presenting OCI in performance-based reports, the FASB in June 2011 issued Accounting Standards Update (ASU) 2011–05 *Comprehensive Income (Topic 220) Presentation of Comprehensive Income*, which eliminated the option of presenting OCI in the statement of changes in stockholders' equity and limits companies to the choice of either the income statement or the statement of comprehensive income (Eaton, Easterday, & Rhodes, 2013).[3]

Does the more prominent display of OCI items help achieve ASU 2011–05's intended objective of improving the comparability, consistency, and transparency of financial reporting (FASB, 2011)? Different theories exist as to whether the presentation format matters for the transparency and valuation of accounting information. If investors are rational in an efficient market, then the presentation format should not matter, as public information disclosed in any format is fully incorporated into the stock price (Eaton et al., 2013). In a departure from the efficient market hypothesis, Hirshleifer and Teoh (2003) assume that investors have limited attention and processing power when modeling firms' choices between alternative means of presenting information. Due to limited attention, investors can process and absorb salient information more easily than less salient information implicit in the public domain. They further conclude that disclosing equivalent information in different formats can have different effects on investors' perceptions due to investors' limited attention. Drawing on this limited attention theory (Hirshleifer & Teoh, 2003), the current study hypothesizes that the new presentation requirement in ASU 2011–05 makes financial statements more transparent and thus more useful to investors.

The sample consists of 1663 firm-year observations pertaining to S&P 500 firms from 2010 to 2013, two years before and two years after the ASU 2011–05 implementation. Two key findings are as follows. First, ASU 2011–05 reduces the continuity of net income from one year to the next by 7% and accelerates the reversal of OCI by 60%.[4] Consistent with the notion that OCI items are transitory in nature (Bamber et al., 2010; Barker, 2004; Linsmeier et al., 1997), the increased OCI volatility makes firms' inherent risk more transparent to investors (Huang, Lin, & Raghunandan, 2016). Second, ASU 2011–05 significantly increases the ability of net income to influence stock prices. Given that OCI and net income are intertwined, the more salient presentation of OCI enables investors to better interpret earnings.[5] After ASU 2011–05, more than 80% of S&P 500 firms choose to report OCI in a separate statement of comprehensive income instead of a continuous income statement (Kim, 2016). This calls for further examination of the pros and cons of these two types of performance reports. The supplemental analysis for the post ASU 2011–05 period indicates that the choice of reporting OCI in either a continuous income statement or a statement of comprehensive income does not have any differential influence on the continuity of earnings from one period to the next or the ability of earnings to influence stock prices.

This paper has policy implications for standard setters regarding the OCI presentation. When presented in a performance statement, the OCI information should be more helpful to financial statement users in their assessment of firms' business activities and future cash flows (FASB, 2011). Supporting FASB's position, the findings suggest that ASU 2011–05 improves transparency and usefulness of the reported OCI information. Allowing a separate statement of comprehensive income, the FASB (2011, 45) "reasoned that this two-statement approach achieves the same objectives as a single statement because the statements would be consecutive and would end with a total for comprehensive income, adequately increasing the prominence of other comprehensive income." Evidence that OCI presented in a continuous income statement has the same effects on earnings continuity and value implications as OCI in a statement of comprehensive income reinforces FASB's notion that the key difference is between a performance report and a non-performance report, rather than between two different types of performance reports.

This paper also contributes to two streams of the accounting literature. First, the study adds to the literature on financial statement presentation by documenting that the more prominent display of OCI in a performance report improves the transparency of financial reporting. Previous studies, only focusing on items within the income statement, find that the closer the line item to the top line in the income statement, the greater its effect on stock prices or future earnings (Bartov & Mohanram, 2014; Bradshaw & Sloan, 2002; Fairfield, Sweeney, & Yohn, 1996; Lipe, 1986; Ohlson & Penman, 1992; Strong & Walker, 1993). Second, the study adds to the OCI literature that has yielded mixed evidence so far. While experimental studies find that OCI information reported in the income statement can help investors extract useful information (Hirst & Hopkins, 1998; Maines & McDaniel, 2000), archival studies show that investors only react to OCI information reported in the statement of changes in stockholders' equity (Chambers, Linsmeier, Shakespeare, & Sougiannis, 2007; Lin, Martinez, Wang, & Yang, 2017). Deviating from the assumption in Chambers et al. (2007) and Lin et al. (2017) that the OCI presentation format affects only OCI, this paper conjectures that the OCI presentation format can also have an effect on net income. Specifically, it is uncovered that displaying OCI in a performance report enhances the ability of net income, rather than OCI, to influence stock prices. While Collins, Maydew, and Weiss (1997) document the decline of earnings' effect on stock prices in past decades, the current study suggests that improving the salience of OCI would mitigate this trend by improving the ability of earnings to influence stock prices. These findings, new to the OCI literature, provide evidence to the FASB that the more salient OCI presentation under ASU 2011–05 improves the usefulness of earnings.

The rest of the paper is structured as follows. The next section discusses sample selection and descriptive statistics. The third section presents empirical findings. The last section concludes.

2. Sample selection and descriptive statistics

Table 1 describes the sample selection. Starting with the Compustat S&P 500 Index constituents in 2010, the initial sample tracks these 500 firms over from 2010 to 2013, two years before and two years after ASU 2011–05.[6] The OCI presentation format information is hand-collected from firms' 10-K filings. The sample loses 36 observations due to missing 10-K filings[7]; 38 observations due to

[3] Effective for fiscal years beginning after December 15, 2011, ASU 2011–05 focuses on the change of the OCI presentation format. Other issues, such as the calculation of OCI items, the reporting about the reclassification from OCI to net income, and the option to report OCI either before tax or net of tax, are not changed. The FASB made the change to increase the prominence of OCI information, which may improve investors' recognition and understanding of OCI. In addition, the change also makes U.S. GAAP and international financial reporting standards (IFRS) more convergent in terms of OCI presentation (FASB, 2011).

[4] Similarly, Jones and Smith (2011) find that OCI gains and losses exhibit reversal, which may be due to the reclassification of gains and losses out of the balance sheet account Accumulated Other Comprehensive Income (AOCI) and into net income. They illustrate this scenario with an example in footnote 11 on page 2052.

[5] Note that OCI itself does not contribute to a firm's value, which is consistent with the evidence that OCI adds little information to net income in explaining stock prices (Dhaliwal, Subramanyam, & Trezevant, 1999; O'Hanlon & Pope, 1999; Cahan, Courtenay, Gronewaller, & Upton, 2000).

[6] This sample construction is driven by the adoption of a pre-post quasi-experiment research design, where the treatment effect is ASU 2011-05 issued by the FASB.

[7] One or multiple years of 10-K filings are missing for 19 firms, which translates to 36 missing firm-year observations. Specifically, the 10-K filings are missing for 17

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