AN ANALYSIS OF COMPREHENSIVE INCOME AS A MEASURE OF COMPANY FINANCIAL PERFORMANCE

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Abstract

Recent changes in accounting regulatory framework have resulted in the introduction of comprehensive income as a primary performance measure. The association between comprehensive income and company financial performance are analyzed and explored in the paper. It is concluded that the superiority of comprehensive income and its components over net income for the prediction of performance is still an issue in question. The mandating uniform disclosures of comprehensive income components for all industries are challenged as they are irrelevant to investors’ decisions.

Key words: comprehensive income, net income, company financial performance.

Introduction

Performance measurement plays a crucially important role in investors’ decision making. For decades net income has been accepted as a key financial performance indicator. However, recent changes in accounting regulatory framework have resulted in the introduction and enforcement of comprehensive income as a primary performance measure. There is much controversy about the superiority of the new indicator over net income in practice (Keating, 1999; LeManh, 2010).

This paper aims to explore the association between comprehensive income and company financial performance. In order to achieve the aim the following research tasks have been formulated. First, the paper provides a brief insight into the origins of comprehensive income theory. Secondly, it analyzes the role played by comprehensive income disclosures in investors’ decision making. Finally, it critically examines the value relevance of comprehensive income and its components for the prediction of company financial performance and puts forward proposals for increasing the usefulness and the predictive power of income.

Various research methods such as analysis, synthesis and comparative literature studies were used to perform the research tasks.

Concepts of income measurement

Income can be calculated using two methods such as balance sheet or asset-liability approach and revenue-expense approach. According to the former, the profit is calculated as a change in net assets, whereas according to the latter, it is a difference between revenues and expenses. These different approaches infer various ways of recording transactions. The balance sheet approach suggests that a transaction is recorded as revenue or an expense if it is not an asset or liability. Thus it is assumed that the income is a residual value. As revenue-expense approach is concentrated on the proper application of matching principle and conservatism, the balance sheet implicitly gets the status of a residual statement. Although nowadays US GAAP and IFRS favour a balance sheet approach, previously this preference was not stated clearly and was changed several times. In the 19th century in the United Kingdom the balance sheet was the essential financial statement whereas a profit and loss account was just its supplement. The financial crisis of 1929 identified several drawbacks of this approach and contributed to the awareness of the growing importance of a profit and loss account. (LeManh 2010: 3)

Historically, there have been following concepts of income measurement in accounting: current operating or dirty surplus, and all-inclusive or clean surplus concepts. The advantage of the former is that only recurrent costs and revenues as results of ordinary and regular operations are reflected in the income statement, whereas irregular gains and losses are charged directly to the retained earnings. By contrast, supported by the American Accounting Association, the all-inclusive concept suggests that in the income statement all the elements which cause the changes in equity except transactions with owners should be included, as they are directly or indirectly related to current activity of the entity (Dhaliwal, 1999: 45; Pascan, 2010: 187). Thus, comprehensive income can be considered as a logical practical application of the clean surplus concept.

Nevertheless, the American Institute of Accountants, as an ardent proponent of current operating concept, has pointed out some drawbacks of the all-inclusive concept. For example, the inclusion of extraordinary components reduces the opportunity to use income as a source of relevant information for future predictions. As these components usually stem from an extremely volatile market, it is almost impossible for company executives to manage them (Dhaliwal, 1999: 45). Other researchers are of the same opinion. For instance, Black (1993: 5) outlines, “We can choose rules that minimize transitory components of earnings, while leaving the permanent components”. However, Keating (1999: 338) takes issue with this argument and stresses that unrealized gains and losses are the result of financial instruments whose management efficiency is an indicator of company executives’ skills and qualification. Similarly, for Barlev and Haddad (2003: 410) comprehensive income concept is closely connected to fair value accounting, providing an equal level of
disclosure and transparency. The main conclusion to be drawn is that comprehensive income is an aggregate measure of company performance.

The United Kingdom was the first country to adopt the concept of overall performance, passing Financial Reporting Standard No. 3 Reporting Financial Performance in October 1992 and introducing a statement of total recognized gains and losses. This concept was based on the theory of comprehensive income which emerged in the USA in 1980 when the Financial Accounting Standards Board adopted Statement of Financial Accounting Concepts (SFAC) No. 3: Elements of Financial Statements of Business Enterprises. According to the Statement, comprehensive income is „the change in equity of a business enterprise during a period from transactions and other events and circumstances from non-owner sources” (Pascan, 2010: 186-187). Later the above was implemented in International Accounting Standard No. 1 as “total comprehensive income”.

Disclosure of comprehensive income

From the very beginning of practical application comprehensive income and its disclosure have been a contentious issue for both practitioners and academics. Even in the stage of initial elaboration the comprehensive income reporting did not have many proponents. An analysis of comment letters (Yen et. al., 2007) submitted to the Financial Accounting Standards Board in response to the Comprehensive Income Reporting Exposure Draft revealed that except academics and “other respondents” who formed groups of almost equal size, there was a strong opposition to the draft among other groups. If an unequivocal support for the comprehensive income reporting was expressed in 14 letter (5 %), the opposition to the proposal was found in 215 (77 %) letters. 41 (15 %) letter authors expressed their partial support for more detailed disclosure of dirty surplus items and/or the concept of comprehensive income reporting.

As a comparative analysis carried out by authors shows, nowadays it still retains controversy. After giving financial analysts modified versions of financial statements of the same fictitious company, Hirst and Hopkins (1998: 68) have established that the disclosure of comprehensive income in a separate statement makes it easier to assess an earning management and improves its transparency. At the same time, according to a poll carried out by Arab-Mazar Yazdi and Radmehr (2003)1, financial information users in Iran support the disclosure of comprehensive income components but are against their presentation in a separate report. Similarly, Maines and McDaniel (2000: 200-201) have explored non-professional investors’ opinion and pointed out that the financial statement format for presentation of comprehensive income does not have any notable effect on their perception of information. Nonetheless, the format is important to the evaluation of information significance and consequent investor’s decisions. According to Chambers et. al. (2007: 590-591), comprehensive income is considered useful for financial market only if the initially used data are published. By contrast, the publication of components, in other words, reconstituted other comprehensive income2 (hereinafter -OCI), does not affect investors’ decision. The same inference can be drawn from another study focused on the effectiveness of comprehensive income disclosure in the statement of changes in equity in New Zealand (Cahan et. al., 2000: 1296-1297). No evidence has been found that components of comprehensive income are informative and incrementally value relevant to comprehensive income. The main conclusion is that disclosure of comprehensive income in financial reporting is important to the investors. However, the usefulness of disclosure of OCI components is highly questionable.

Actually, the usefulness of disclosure of comprehensive income could be indirectly determined by national accounting practice. J. Saghroun (2003)3 explored the perception of net income by financial analysts in France. The majority of respondents described net income as an indicator of company business performance and not as an indicator of change in company value. They were not able to give a clear explanation of the term “comprehensive income”. Carrying out the interview before the implementation of the IFRS in France and uncommon nature of the transactions which resulted in the direct record of items in equity under French accounting regulation were mentioned by J. Saghroun as a possible reason for this paradoxical situation.

Predictive power of income and income components

Although there have been numerous academic studies into a value relevance of comprehensive income and its components compared to net income for the prediction of future stock prices, most results are not definitive and often contradict each other. Dhaliwal et. al. (1999: 47, 60) have concluded that net income is a

1 Arab-Mazar Yazdi, M., Radmehr, K., 2003. A survey of the significant and necessity of comprehensive income statement in Iran. Iranian Accounting and Auditing Review 31, 51-73. Quoted from (Dastgir et.al., 2008: 125)
2 “Other comprehensive income comprises items of income and expense including reclassification adjustments that are not recognised in profit or loss as required or permitted by other International Financial Reporting Standards”. These items are as follows: changes in revaluation surplus, actuarial gains and losses on defined benefit plans, gains and losses arising from translating the financial statements of a foreign operation, gains and losses on re-measuring available-for-sale financial assets, the effective portion of gains and losses on hedging instruments in a cash flow hedge (International...).
better predictor of market value of equity, future operating cash flows and income than comprehensive income. In addition, they have found that, with the exception of adjustments to available-for-sale financial assets, other components of OCI impaired the association between income and returns. However, detailed analysis has revealed that these findings were owing to the inclusion of financial sector companies in the sample. Similar results have been provided by Dastgir et. al. (2008: 128) who have based their study on the sample of listed companies in the Tehran Stock Exchange in 2001-2003. It has been observed that neither at aggregate nor industry level, except mine and cement industries, the comprehensive income is a better measure of company performance evaluated by stock returns compared to net income. These findings are analogous with the results reported by Wang et. al. (2006: 401-402). Their study has focused on both relative and incremental value relevance of the current operating concept in Dutch companies within the period from 1988 to 1997. The conclusion has been drawn that both net income and comprehensive income are useful for prediction of stock return, but net income is more relevant and preferable. After the examination of net income and comprehensive income under various regulations (European local GAAP, IFRS and USA GAAP in the latter) Goncharov and Hodgson (2008) have also identified the former as a better predictor of future operating cash flows under any regulative framework.

Prior to the adoption of SFAS 130, there was an attempt to explore the ability of operating income, net income and comprehensive income to predict stock returns (Cheng et. al., 1993: 201-202). The highest correlation was identified with operating income. Moreover, its components had incremental value, whereas the components of comprehensive income did not. Nevertheless, diametrically opposed results are reported by Ramond et al. (2007) after examining the data from French and UK listed companies in the years 1993-2005. The comprehensive income is found to be less relevant, but, by contrast, OCI to be value relevant in comparison with net income. This conclusion has been partly reinforced by a study on companies listed in the German stock market index HDAX over the years 1998 and 2007 (Zülch et. al., 2010: 18, 31-32). The study has indicated neither superior predictive power of comprehensive income over net income nor significant incremental predictive power of aggregated or individual components of OCI for company operating performance in a successive period. Furthermore, it has been demonstrated that the disclosure of actuarial gains and losses on defined benefit pension obligations adds an insignificant complication to the prediction of net income and comprehensive income in a subsequent period. At the same time, OCI components have incremental predictive power beyond one period.

A diametrically opposed conclusion can be found in research done by Kanagaretnam et. al. (2009: 364) who identify a better predictive power of a current period’s comprehensive income for Canadian companies’ future net income, future comprehensive income and future operating cash flows. It is maintained that a security market definitely benefits from incremental value-relevant information provided by comprehensive income and its components. Other researchers (Choi et. al., 2006; Choi et. al., 2007) agree that comprehensive income is a superior predictor for future net income. However, it is denied that OCI components can be used to predict future net income (Choi et. al., 2006). A significant correlation between large positive value of OCI components and an increase in successive period’s net income is attributed to the arbitrary decision of company managers about the moment when OCI components are recognized. It is mentioned (Zülch et. al., 2010: 9) that usually unrecognized OCI losses are not recognized as long as they decline or become gains. Thus, their negative impact on net income is avoided. The implicit conclusion can be drawn that recognition entirely depends on company performance.

Conclusions

This paper has explored the association between comprehensive income and company financial performance. The development of the all-inclusive concept of income measurement has resulted in the emergence of a theory of comprehensive income, which plays an important role in investors’ decision-making process. This concept was first adopted by the Financial Reporting Standard No. 3 (1992) in the United Kingdom. However, the theory of comprehensive income which the concept was based on emerged earlier in the USA and was stipulated by Statement of Financial Accounting Concepts No. 3 (1980).

It has been established by numerous studies that in general the investors support the disclosure of comprehensive income as this additional information is important to their decision making. Nevertheless, just few investors are of the opinion that this disclosure should be provided in a separate statement. No evidence has been found that components of comprehensive income are informative and incrementally value relevant to the investor’s decision making. The superiority of comprehensive income and its components over net income for the prediction of company financial performance is still an issue in question, as the results of empirical studies are contradictory. The results of most studies show that neither at aggregate nor industry level comprehensive

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income is a better predictor of market value of equity, future operating cash flows and income than net income. Moreover, components of net income have incremental value for the investor’s decision making, whereas the components of comprehensive income do not. Nevertheless, a significant number of studies claim that the value relevance of comprehensive income outweighs the one of net income.

These inconsistencies can partly be attributed to a diversity of the regulative accounting framework in countries where the studies are carried out. In addition, a relative lack of representative sample of examined companies can be mentioned as another reason. While net income is acknowledged by most researchers as a prevailing measure of company financial performance, additional more detailed and consistent studies are required to refute this paradigm. In authors’ opinion, the usefulness of mandating uniform disclosures of comprehensive income components for all industries should be discussed and re-examined, as they are not relevant to investors’ decisions. An arbitrary disclosure might contribute to the overall conciseness and relevance of financial reporting.

References


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Santrauka


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Prasminiai žodžiai: bendrosios pajamos, grynosios pajamos, įmonės finansinės veiklos rezultatus.