On the Relevance of Reporting Comprehensive Income under IAS / IFRS: Insight from Major European Capital Markets

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Presentation Overview (1/1)

Introduction: Scope of the IASB / FASB Performance Reporting Project

Part I. Purposes of the study and research framework

Part II. Empirical results: Some preliminary comments

Conclusions: Main results and future research avenues
Introduction (1/1)

In October 2003, the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) formed a Joint International Group (JIG)

Objective: “to establish standards for the presentation of information in order to enhance the usefulness of that information in assessing the financial performance and financial position of an entity” (IASB, 25th of October 2004).

Initially entitled “Performance Reporting: Reporting Comprehensive Income”

Is mainly concerned with the presentation and disclosure of financial performance information in financial statements under IAS / IFRS and US GAAPs

Why such a project?

The proliferation of alternative and inconsistent financial performance measures are prejudicial to high-quality financial reporting,

Homogeneous information is not only essential to any well-informed investment decisions but is also propitious to efficient capital markets.
Highlights

- Adopt a broader concept of financial performance (i.e. comprehensive income) instead of a single performance measure (i.e. bottom-line earnings)

- Political lobbying pressure made by various US-based professional bodies

- “[…] the increasing number of wealth changes that elude disclosure on the income statement. […] calls for the display of comprehensive income that allows components of different character to be seen and evaluated separately.” (AIMR, 1993: 63).

- “[…] The financial statements must recognize, as they occur, all events or transactions that affect the value of the company’s net assets and, hence, common shareowner’s wealth.” (CFA Institute, 2005: 10).
Summary Accounting Income Measures: Prior consideration (2/4)

The «Income Russian Dolls Pyramid»

- Operating income
- Non-operating income and expense
- Other comprehensive income (OCI)
- Net income
- Comprehensive income (CI)

US SFAS 130 terminology

Disclosure location:
- P&L account
- Statement of Equity Sharehold’ change
Prior consideration: What are OCI / CI items?

What is Comprehensive Income (CI)?
- It is the change in equity [net assets] during a period except those resulting from investments by owners and distributions to owners (i.e. dividends and capital change)
- CI differs from the traditional net income measure as it encompasses ‘other comprehensive income’ (OCI)

What are OCI?
- These are accounting items that are directly taken to shareholders’ equity and bypass the income statement
- E.g. Under IAS / IFRS & US GAAPs,
  - foreign currency translation gains and losses,
  - Cash flow hedge
  - actuarial gains and losses
  - asset revaluations
Threefold question:

- **Decision-making usefulness**: Are comprehensive income and its components used by investors for investment decision making? Are they consistently used by investors in different countries?

- **Value Relevance**: Whether ‘comprehensive income’ provides incremental price relevant information beyond net income across countries and whether it should be legitimately introduced into the international accounting standards?

- **Disclosure materiality**: Should firms across countries be required to disclose these summary measures consistently on the face of ‘Statement of Comprehensive Income’?
Summary Accounting Income Measures: Prior empirical results (1/2)

Empirical evidence have been mainly provided by US-based studies

Is CI superior to NI in terms of value-relevance? (Pre-SFAS 130)
- No evidence
- Evidence
  - e.g. Biddle and Choi (2006)

Are OCI and its components valued by the market?
- Chambers et al (2006): Not in the pre-SFAS 130 period but OCI such as marketable security adjustments and foreign currency translation adjustments for all firms are valued in the post-SFAS 130 period
- Biddle and Choi (2006): OCI and all its components for all firms
Summary Accounting Income Measures: Prior empirical results (2/2)

- UK evidence from Lin (2006)
  - FRS No.3 requires ‘Statement of Total Recognized gains and losses’, including net income and components of OCI
  - OPI and its components are value relevant and provide incremental price information beyond net income
  - Some OCI components are value relevant and provide incremental price information beyond net income

- As a conclusion, empirical evidence in the US and the UK are mixed
Purposes of this study (1/2)

- Evaluate the IASB and FASB joint project on reporting financial performance

- At a European level

- by providing preliminary empirical evidence on
  - the usefulness,
  - the value relevance, and
  - the disclosure economic consequences of comprehensive income and its components (i.e. operating income, net income and other comprehensive income)
Purposes of the study: Research Questions

(2/2)

- To what extent ‘comprehensive income’ and its components are value relevant to investors in countries with very different legal, social, and economic environment?

- Does comprehensive income, at an aggregate level, provide incremental value-relevance beyond net income or operating income in the European financial markets?

- Do ‘dirty surplus flows’ or OCIs provide incremental value-relevant information beyond traditional net income?

- Can we observe differences in value-relevance between ‘reported comprehensive income’ and ‘non-reported comprehensive income’? In other words, is ‘comprehensive income’ more value-relevant when it is clearly disclosed on the face of the financial statements than when it is not?
Sample and Data (1/1)

- Sample made of listed firms in five major EU stock markets, i.e. UK, Germany, France, Italy and Spain
- Accounting and financial data collected from Datastream and Worldscope
- Period of analysis: 1993 – 2004 (pre- IAS compliance period)
  - 2005 data are left for robustness checks purpose
- Financial firms were excluded
- The final sample (after outliers treatment) contains around:
  - UK: 7,000 obs
  - Germany: 4,500 obs
  - France: 4,000 obs
  - Italy: 1,200 obs
  - Spain: 700 obs
Research design (1/2)

- Based on the Ohlson’s (1991) model framework
  - Comprehensive income is measured as:
    \[ CI_t \equiv \Delta BV_t - N_t + d_t \]
    \[ OCI_t = CI_t - NI_t \]
  - Usefulness and value-relevance of the three Accounting Income (AI)
    measures (i.e. Net, Operating and Comprehensive income) are
    respectively assessed by the following Return-Earnings OLS slope
    coefficients significance and \( R^2 \):
    \[ RET_t = \beta_0 + \beta_1 \frac{AI_t}{P_{t-1}} + \beta_2 \frac{\Delta AI_t}{P_{t-1}} + u_t \]
  - Conventional and ranking OLS methodology are used
Research design (2/2)

How to compare value-relevance between AI measures?

- Non-nested tests: the Vuong (1989) test is performed to compare value-relevance of AI amongst earnings-return models.

- Nested tests: Additional information provided by OCI beyond NI is measured by $R^2$ increases observed between the following two nested-models:

$$RET_t = \gamma_0 + \gamma_1 \frac{NI_t}{P_{t-1}} + \gamma_2 \frac{\Delta NI_t}{P_{t-1}} + u_t$$

$$RET_t = \gamma_0 + \gamma_1 \frac{NI_t}{P_{t-1}} + \gamma_2 \frac{\Delta NI_t}{P_{t-1}} + \gamma_3 \frac{OCI_t}{P_{t-1}} + \gamma_4 \frac{\Delta OCI_t}{P_{t=1}} + u_t$$
Empirical Results (1/4)

Empirical evidence indicate that:

- OPI, NI and CI are all associated with share returns in all five EU countries
  - OPI is more value-relevant than NI and CI in the UK setting
    - This could be due to the OPI disclosure requirement made by FRS 3
  - NI clearly dominates CI and OPI in all continental EU countries

- In all cases, CI provides much less value-relevance than NI and OPI
  - Consistent with US evidence

- OCI is value-relevant and provides incremental value-relevance beyond net income
  - Very different from US findings

- These results may be driven by IAS / US GAAPs early-adopters
### Empirical Results: Early adopters table (2/4)

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<td>Total Firm-Y obs.</td>
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<td>376</td>
<td>4.58%</td>
<td>192</td>
<td>5.57%</td>
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|            | out of 7,130 | out of 8,216 | out of 3,445 | out of 1,339 |
Empirical Results: Robustness checks (3/4)

- Sensitivity tests on German early-adopters:

- Early (IAS and US) adopters in Germany increase the explanatory power of OCI for share return

- Further tests indicate that US early adopters exhibit high OCI value-relevance compared with IAS or local standards followers
  - This result provides evidence supporting Beaver’s (1981) and Hirst & Hopkins’ (1998) psychology-based financial reporting theory
    - Information is valued by investors only when it is directly readable (from a firm’s financial statements for instance)

- Other sensitivity tests:

- Robustness checks conducted on the return variable, the period of analysis, SIC industry did not point out any major outcomes’ differences
This study provides 4 main findings:

- Operating income, net income, and comprehensive income are all value relevant, although their usefulness varies across major European markets.

- Net income dominates comprehensive income and operating income except in the UK.

- Other comprehensive income is generally value relevant.

- Early adoption of IFRS or US GAAP increases the return-CI relationship.
Conclusions (1/1)

- Summary accounting income measures are generally value relevant across major European markets.

- Information contained in summary accounting income measures varies due to the differences in socio-economic environment across borders.

- Adoption of Anglo-American accounting system increases the relationship between return and comprehensive income perhaps due to the following two reasons:
  - Clear disclosure of comprehensive income, other comprehensive income and its components in financial statements
  - Mark-to-market accounting practices (fair value accounting)

- Results generally support the rationale underlying the IASB project.

- Future research should investigate the IFRS introduction impact on the value relevance and usefulness of individual OCI items.
Thank you for your attention