A new measure of financial performance: the comprehensive income – opinions and debates

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Abstract: Performance represents a controversial notion, taking into consideration the multitude of meanings and dimensions used in order to define it, and on the other side the difficulty of measuring performance in the context of informational necessities of the different categories of stakeholders. In the recent years, different accounting regulation bodies are focused on a new measure of financial performance, the comprehensive income. The objective of our paper is to present the opinions related to the usefulness of comprehensive income in measuring the financial performance of an entity. The research methodology involves the study of the accounting literature.

Key-Words: Comprehensive income, Performance, Accounting regulations, Financial statements, Stakeholders, Fair value

1 Introduction
The objective of financial statements, according to the IASB Framework for the Preparation and Presentation of Financial Statements, is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions. According to the IASB Framework, “performance is the ability of an entity to earn a profit on the resources that have been invested in it. Information about the amounts and variability of profits helps in forecasting future cash flows from the entity's existing resources and in forecasting potential additional cash flows from additional resources that might be invested in the entity”.

The ability of the Income statement to measure the financial performance was and still is controversial. Why is it controversial? A first possible answer is that, in the current context of the existence of various accounting options for reflecting the same transaction, there is no objective income. In order to appreciate the financial performance of an entity based on the information presented in the financial statements, it is necessary to know the accounting policy of that particular entity [1].

On the other hand, through its way of calculation, the income presented in the Income statement is oriented toward the past, serving as a measurement of the progress recorded by an entity during a past period of time. The objective of the financial statements is not only to inform of the past performance, but also of the future performance: what is the ability of published income to predict future performance?

The accounting profession, the researchers and, especially, the accounting regulation bodies, IASB (International Accounting Standards Board), FASB (US Financial Accounting Standards Board), ASB (UK Accounting Standards Board) and others, are preoccupied with finding solutions regarding the improvement of the financial performance reporting process. Their debates are lately focusing on a new measure of financial performance, the comprehensive income.

We believe that it is relevant for our research to present in a few words the history of comprehensive income in the standard setting process. In 1980, the Financial Accounting Standards Board (FASB) formally introduced the concept of comprehensive income to the accounting literature in Statement of Financial Accounting Concepts (SFAC) No. 3: Elements of Financial Statements of Business Enterprises and defined it as „the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources” [2].

The FASB did not formally propose reporting comprehensive income until the mid-1990s. The FASB’s deliberations on the comprehensive income project began in November 1995 and the FASB issued an Exposure draft of the proposed standard for public comment on June, 1996. In June 1997, the FAS 130 Reporting Comprehensive Income was published by FASB, standard that makes reference to the presentation and publishing of the comprehensive income. This
standard that was put into operation starting with 15th December 1997 mentions that when determining the comprehensive income one has to take into account the effects of all operations and events which occurred during the exercise and which contributed to the increase and decrease of equity (with the exception of the shareholders and partners’ contribution and the distributions in their favour). Any profit or loss accounted during the accounting period, made or not and regardless of its nature, contributes to the entity’s financial performance and, therefore, it has to be included in the comprehensive income statement.

In the United Kingdom, the Accounting Standard Board (ASB) was the first organism which introduced the concept of overall performance. Thus, through the Financial Reporting Standard no. 3 (FRS 3) Reporting financial performance, adopted in October 1992, a Statement of Total Recognized Gains and Losses was issued. “The statement of total recognized gains and losses is a primary financial statement that enables users to consider all recognized gains and losses of a reporting entity in assessing its overall performance. It, therefore, includes the profit or loss for the period together with all other movements on reserves reflecting recognized gains and losses attributable to shareholders. The statement is not intended to reflect the realization of gains recognized in previous periods nor does it deal with transfers between reserves, which should continue to be shown in the notes to the financial statements” [3].

The necessity of publishing such a financial statement is justified by the ASB through the incapacity of the profit and loss account to offer a complete picture on financial performance, if one takes into account the fact that British accounting standards allow the direct and loss account to offer a complete picture on financial performance and, therefore, it has to be included in the comprehensive income statement.

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The necessity of publishing such a financial statement is justified by the ASB through the incapacity of the profit and loss account to offer a complete picture on financial performance, if one takes into account the fact that British accounting standards allow the direct and loss account to offer a complete picture on financial performance and, therefore, it has to be included in the comprehensive income statement. Until 2004, the International Accounting Standards Board (IASB) also developed a project regarding the improvement of reporting the financial performance by means of financial statements, project entitled “Performance reporting”; and later on “Reporting Comprehensive Income”. Aiming to achieve an international accounting convergence, in April 2004, IASB and FASB agreed on the fact that such a project should be commonly accomplished, starting from the previous results obtained by each organization. Thus, starting with November 2004, the project entitled “Financial Statement Presentation” was initiated, aiming to set standards for presenting information within the financial statements with the purpose of improving the usefulness of this information in the process of assessing the entity’s financial performance. In March 2006, the IASB issued the Exposure draft of proposed amendments to IAS 1, concerning the statement of recognised income and expense. Under the Exposure draft, an entity would have a choice of presenting income and expenses in a single statement or in two statements. At present, according to the International Accounting Standard no. 1 (IAS 1) Presentation of Financial Statements, revised on 6th September 2007, IASB requested the presentation of all changes in equity, others than the ones related to the transactions with the owners, either in just one financial statement – Statement of comprehensive income – or in two financial statements – the Income Statement and the Statement of Comprehensive Income. The effective date of IAS 1 revised in September 2007 is 1st January 2009, but an anticipated adoption was allowed.

According to IAS 1, Comprehensive income for a period includes profit or loss for that period plus other comprehensive income recognised in that period. The components of other comprehensive income include:
- changes in revaluation surplus (IAS 16 and IAS 38);
- actuarial gains and losses on defined benefit plans recognised in accordance with IAS 19;
- gains and losses arising from translating the financial statements of a foreign operation (IAS 21);
- gains and losses on remeasuring available-for-sale financial assets (IAS 39);
- the effective portion of gains and losses on hedging instruments in a cash flow hedge (IAS 39).

The objective of our paper is to identify the usefulness of comprehensive income in measuring the financial performance of an entity. Our study is based on the empirical and theoretical researches published in the accounting literature. The reminder of the paper is structured as follows. In the second part we present an empirical study on the opinions on comprehensive income. Then, we summarize the pro and contra arguments regarding the comprehensive income from the related literature. We present the comments and the results of the published studies and end with concluding remarks.

2 Empirical study on the opinion on the comprehensive income

In the period of the development of the Income statement, there were two opposite trends with respect to the field of observing performance [12]: a current operating concept and an all inclusive concept. The American Institute of Accountants (AIA), which later became the American Institute of Certified Public
Accountants (AICPA), welcomed the “current operating concept” or “dirty surplus concept”. The supporters of this concept want to include, in the Income statement, only the consequences of the ordinary, regular operations, normal for the current period and carry directly to the retained earnings the irregular gains and losses that do not reflect an entity’s future earning power. The elements specific to the operating activities are considered ordinary, recurrent, allowing forecasts of future financial performances, as well as comparisons in time and space of these performances. This theory complies with the priority given to the Income statement. The disadvantage of this concept is the fact that, by reporting only the recurrent costs and revenues in the Income statement, other factors which influence performance, sometimes very important, remain unknown.

On the other hand, The American Accounting Association (AAA) is the supporter of a broader definition of financial performance – the “all inclusive concept” or “clear surplus concept”. According to the all inclusive concept, the result includes all the elements that affect the growth and the diminution of the equity during that period, excepting the transactions with the owners. This concept suggests that unusual or extraordinary elements have to be included in the result, because, any gain or loss, directly or indirectly related to the current activity of the entity, contributes to its profitability in the long run.

Therefore, the reporting of the comprehensive income would be in conformity with the all inclusive concept, contributing to reaching the fundamental objective of reporting the results as a measure the entity’s management efficiency.

The concept of comprehensive income is controversial. Our study will present the opinions on the comprehensive income, collected from the literature, relating the value relevance of comprehensive income, the necessity of comprehensive income reporting in the conditions of the use of fair value accounting, the advantages or disadvantages of comprehensive income in relation to the net income.

2.1 The research methodology and hypotheses

Our study consists in a basic research and the research methodology is preponderant deductive. The research methods used in order to accomplish the stated objectives are mainly qualitative, based on the bibliographic documentation. We employed observation methods, such as the study of related literature, the analysis, the participatory observation.

The main research objective is to develop a critical analysis, based on the accounting literature, regarding the opinions related to the usefulness of comprehensive income in measuring the financial performance of an entity.

A similar methodology was used by Matis, D. and Bonaci, C. in an empirical study on the opinions related to the fair value and guidance in a crisis period [5]. Their research was based on the articles regarding the fair value, published in the ISI journals of accounting, during 2005-2009.

In order to identify the scientific documents on which we have developed our research, we employed the following methodology. We have chosen the Science Direct database of research literature, because we were able to access a large number of full text available articles. The selection of the articles included in our research was made based on some parameters. Thus, we search for the term “comprehensive income” in all journals of business, management and accounting, in all years (as we were interested in the evolution in time of this concept) and in all fields (the title, key words, abstract and full text of the articles). The database query led to a total number of 109 articles, published during 1985-2010. It is interesting to notice that the concept of comprehensive income was mentioned in scientific papers science 1985. After reviewing these 109 articles, totaling over 2,100 pages, we select a number of 13 articles related to the comprehensive income.

In the next table, we present the articles included in our study, according to the journal title and the year they were published:

<table>
<thead>
<tr>
<th>Journal title</th>
<th>Year</th>
<th>Number</th>
</tr>
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<tbody>
<tr>
<td>Journal of Accounting Education</td>
<td>1999</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>2003</td>
<td>1</td>
</tr>
<tr>
<td>Journal of Accounting and Public Policy</td>
<td>2002</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>1</td>
</tr>
<tr>
<td>The International Journal of Acc.</td>
<td>1998</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>2006</td>
<td>1</td>
</tr>
<tr>
<td>Acc., Organization and Society</td>
<td>2000</td>
<td>1</td>
</tr>
<tr>
<td>Critical Perspectives on Acc.</td>
<td>2003</td>
<td>1</td>
</tr>
<tr>
<td>Journal of Acc. and Economics</td>
<td>1999</td>
<td>1</td>
</tr>
<tr>
<td>Journal of International Acc., Auditing and Taxation</td>
<td>2001</td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>2009</td>
<td>1</td>
</tr>
<tr>
<td>Research in Acc. Regulation</td>
<td>2007</td>
<td>1</td>
</tr>
<tr>
<td>The British Accounting Review</td>
<td>1999</td>
<td>1</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td></td>
<td><strong>13</strong></td>
</tr>
</tbody>
</table>

The research hypothesis that we wish to test can be formulated as follows:

H1: The theoretical articles sustain the usefulness of the comprehensive income in measuring the financial performance of an entity;

H2: In the Anglo-Saxon accounting systems, there is a great interest for the reporting of comprehensive income.
2.2 Results and findings
Considering the important stages in the evolution of the regulation of comprehensive income stated above, our study seeks to identify whether there is a connection between these stages and the opinions presented in the research papers that we selected. Thus, we have classified the studied articles into two categories, theoretical and empirical, and have grouped them according to the year of their publication. We find that 9 articles were written between 1998 – March 2006 (5 of them theoretical and 4 empirical) and 4 articles were written between April 2006 – 2009 (1 theoretical and 3 empirical). The margins of the intervals were chosen taking into consideration the following aspects: 1998 represents the year of the oldest publication included in our study and 2009 represents the year of the latest one; March 2006 represents the date when the IASB issued an Exposure draft of proposed amendments to IAS 1 Presentation of Financial Statements. The figures presented show that, prior to the publication of IASB Exposure draft, the number of theoretical studies published was greater than the number of the empirical ones. After the issue of the Exposure draft, the proportion seems to be reversed, due to the interest of the researchers in showing the practical utility, advantages of limits of the comprehensive income, based on empirical studies.

At a first view, it might seem surprisingly that the number of published papers, theoretical and empirical, is greater before the IASB Exposure draft was issued. In fact, the large number of studies published during 1998 – March 2006 can be explain taking into account that in this period the accounting regulations regarding the comprehensive income were already effective in the UK and in the US.

Next, we thought relevant for our research to outline the opinions expressed in the studies taking into account the observation field, meaning the accounting regulation that the articles are focused on or the location of the entities included in the surveys. Accordingly, we find that:

- 7 papers refers to the SFAS 130 “Reporting comprehensive income” issued by the FABS and test the value relevance of comprehensive income components on the US entities [6], [7], [8], [9], [10], [11], [12];
- 2 papers present empirical studies conducted on UK entities [13], [14];
- 1 paper addresses the usefulness of comprehensive reporting in Canada [15];
- 1 paper investigates the value relevance of dirty surplus accounting flows in the Netherlands [16];
- 1 paper investigates the relationship between dirty surplus items and the cost of debt for Japanese firms [17]; and
- 1 paper examines the evolution of the accounting standards issued by IASB, US, UK, Canada and Australia, in order to establish the similarities and the differences between their financial reporting practices, including in the field of reporting comprehensive income [18].

In order to test our research hypotheses, we structured the selected studies into three categories, according to their results and findings. Thus, we labelled the studies in: “pro”, “neutral” or “against”, referring to the opinions on the usefulness and relevance of comprehensive income, expressed by the authors as a product of their research. As a result, the articles surveyed were grouped as follows:

Table 2. Opinions regarding the comprehensive income published in the Science Direct database of research literature

<table>
<thead>
<tr>
<th>Studies</th>
<th>Pro</th>
<th>Neutral</th>
<th>Against</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Theoretical</td>
<td>4</td>
<td>2</td>
<td>0</td>
<td>6</td>
</tr>
<tr>
<td>Empirical</td>
<td>5</td>
<td>0</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>9</td>
<td>2</td>
<td>2</td>
<td>13</td>
</tr>
</tbody>
</table>

As we can see from the table presented above, the number of articles that sustain the usefulness of comprehensive income is high (69% of the surveyed articles are pro comprehensive income). There is no theoretical paper against the reporting of comprehensive income; so, the results validate our first research hypothesis.

From the 13 papers included in our research, most (11 papers, representing around 85% from the surveyed papers) are related to the Anglo-Saxon accounting system: 2 of them refer to UK, 7 – US, 1 – Canada and 1 – Netherlands. In our opinion, these results prove once again that, in the Anglo-Saxon system, the financial information is primarily addressed to investors, the most important category of stakeholders, and investors have predominantly interest for information related to performance. So, our second research hypothesis is true.

3 A synthesis of the opinions regarding the comprehensive income

3.1 Benefits and limits of comprehensive income presented in the theoretical papers
After reviewing the research literature, we ascertain that the biggest supporter of comprehensive income reporting is Keating, M. In her research paper, Keating, M. states that „after years of inadequate income disclosure, FASB issued FAS no. 130, Reporting Comprehensive Income, to attempt a more appropriate income disclosure... Statement 130 is of great value because it follows the evolution of the income statement, meets the demand of financial statement users and harmonizes the international standards.” [12] Financial
statement users need all information regarding the economic activity of an enterprise in one place so they can sort out the information pertaining to their particular need. Drawing attention to other comprehensive income items is of great importance to users making credit and investment decisions. The fact that a company had unrealized gain in a period does suggest stability which is a motivating factor in credit and investment decisions. The disclosure of comprehensive income allows the users to assess possible future cash flows of a company. Comprehensive income conveys information about enterprise resources, claims to those resources and changes in them. Without SFAS 130 users cannot easily make informed decisions. Although she considers that comprehensive income reporting is extremely important for the stakeholders, Maria Keating also presents in the research paper various opinions of some authors that do not trust that comprehensive income reflects better the financial performance of the entity.

One of the arguments against refers to the fact that part of the transactions that lead to unrealized gains and losses are part of an extremely volatile market that makes the management of these unrealized gains and losses almost impossible. Other opponents of comprehensive income state the fact that the other elements of comprehensive income are not related to the financial performance and thus they should not be included in an income statement. The author argued against those opinions, stating that unrealized gains and losses generated by the financial instruments are related to the management performances. The efficiency of hedging operations represents an indicator which shows how efficiently investors’ resources are managed. Therefore, other elements of the comprehensive income are connected with the entity’s financial performance and should be included in an income statement.

Alex C. Yen, D. Eric Hirst and Patrick E. Hopkins presents in their paper the results of a content analysis of comment letters submitted to the Financial Accounting Standards Board in response to the Board’s Comprehensive Income Reporting Exposure Draft [6]. The results of the paper show that the ED was overwhelmingly opposed. With the exception of academics and “other” who were split almost evenly, opposition to the ED was high across all constituent groups. Overall, only 14 letter writers (5%) expressed unilateral support for the FASB’s comprehensive income reporting proposal. In contrast, 215 (77%) letters expressed unilateral opposition to the proposal. Forty-one letter writers (15%) expressed partial support for the ED. These letters supported increased disclosure of dirty surplus items and/or the overall concept of reporting comprehensive income, but opposed how the comprehensive income disclosure would be presented in the financial statements, as outlined in the ED.

Barlev, B. and Haddad, J. R. sustains the importance of comprehensive income reporting and relates the comprehensive income concept with the fair value accounting. In their opinion, the fair value accounting (FVA), in contrast to the historical cost accounting (HCA) that hides the real financial position and income, is more value relevance. Also, the FVA provides also a complete full disclosure and it is compatible with transparency. Although the advantages of financial statements based on FVA are overwhelming, HCA figures are still needed for various purposes (for example, in case of taxable income). Consequently, a dual system of reporting that incorporates FVA and HCA may evolve. A comprehensive income statement may be an alternative or an addendum to a dual system of reporting [9].

3.2 Empirical evidence on the comprehensive income

Kanagaretnam, K., Mathieu, R. and Shehata, M. investigate empirically whether requiring Canadian companies to report comprehensive income and its components provides the securities market with incremental value-relevant information over the traditional historical-cost earnings approach. The study used actual data on other comprehensive income for a sample of Canadian firms cross-listed in the US in the period 1998–2003. The authors find evidence that available-for-sale and cash flow hedges components are significantly associated with price and market returns. They also find that aggregate comprehensive income is more strongly associated with both stock price and returns compared to net income and that net income is a better predictor of future net income relative to comprehensive income. These findings sustain the comprehensive income and suggest that the adoption of the new Canadian accounting standards is expected to enhance the usefulness of financial statements [15].

Wang, Y., Buijink, W. and Eken, R. tests empirically the value relevance of dirty surplus accounting flows in the Netherlands. Their paper explores both the incremental and relative value relevance of dirty surplus accounting flows for the Dutch listed firms in the period 1988–1997. They find consistent evidence that both reported income and clean surplus income are relevant in explaining stock returns, though reported income seems a more relevant measure of returns in the period considered. The results suggest that aggregated dirty surplus flows are not associated with stock returns with accumulation intervals up to 10 years; however, asset revaluations and currency-translation differences are at times incrementally relevant to returns [16].
The results of another research, carried out by Dhaliwal, D., Subramanyam, K.R. and Trezevant, R., show less optimistic conclusions related to the capacity of comprehensive income to express more accurately one entity’s performance. The main objective of the research was to investigate if comprehensive income reflects better the financial performance of one entity than the net income. The conclusion of the research show that net profit is more strongly associated with the market value of the equity it forecasts the future cash flows and earning more accurately than the comprehensive income [10].

4 Conclusion

The statement of comprehensive income contributes to the improvement of the decision-making process, especially for investors, who will have more useful information in forecasting future incomes and cash flows. Also, we believe that the importance and the advantages of comprehensive income will be emphasized after several years of presentation of comprehensive income.

References: