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Financial Accounting Standards Board
Technical Director
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File Reference No. 1790-100 Exposure Draft:
Comprehensive Income (Topic 220)
Statement of Comprehensive Income

Dear FASB:

I would like to make a few comments on the exposure draft from the perspective of a financial statement user and educator. The flexibility in display for comprehensive income that currently exists is not desirable from the perspective of financial statement users. It is certainly time to remove the option to display comprehensive income “buried” within a statement of changes in owners’ equity. My feelings are less strong with respect to eliminating the possibility of having separate statements of net income and comprehensive income. In my comments, I also offer some suggestions that arise from my experience in teaching students to prepare the statement of comprehensive income. I also point out some problems that will trickle down to not-for-profit entities if components of other comprehensive income (OCI) continue to proliferate.

For purposes of classifying comment letters, my title is professor of accounting and I am employed at the University of Idaho. I have held my CPA license since 1977. Prior to beginning my 28-year academic career, I held a variety of positions including staff accountant in a small public accounting firm, controller for several small to medium-size business entities, and as director of finance for a large not-for-profit entity. As an active donor and small investor, I have occasion to read the financial information of charities and publicly-traded companies.

Responses to Specific Questions

Question 1: Do you agree that requiring a continuous statement of comprehensive income will improve the comparability, transparency, and understandability of financial statements such as relationships between changes in the statement of financial position, the components of other comprehensive income, and the components of net income in each period? If not, why not, and what changes would you suggest to the amendments in this proposed Update?

Adopting a single format is a step in the right direction and will enhance comparability. I cannot make the same claim for understandability and transparency. I suspect that financial statement users are not well informed about the issues related to accumulated other comprehensive income (AOCI) components of “other comprehensive income” (OCI), and how comprehensive income itself adds value to the familiar “net income” that has been reported far longer. Accordingly, I’m not necessarily convinced the new format will be better but it will certainly be harder to ignore the question as to whether the important number is net income, income from continuing operations, comprehensive income, etc.¹

Why understandability and transparency will still a problem

One might expect that a reasonably well-informed financial statement user (banker, investor, etc.) might have taken an introductory accounting course at some stage in their life. Such courses are generally required for all business majors and for other nonbusiness degrees as well. However, the reasonably well-informed user will not necessarily have taken intermediate and advanced accounting courses. Due to the complexity of the topics that give rise to OCI and AOCI, preparation of the statement of comprehensive income cannot be easily taught in introductory courses or other user-oriented training programs. I can imagine trying to explain what it is all about to the ladies in my investment club! I might tell them that OCI contains gains and losses that “someone” decided would add too much volatility to net income. While that makes it sound like the standard setters are facilitating the cooking of corporate books, at least all companies are required to follow the same recipe. In other words, the reported numbers for net income and comprehensive income have the virtue of comparability across companies. I could probably make the rationale behind OCI treatment for available for sale investments and pension items comprehensible, but I’d surely lose them if I tried to explain the foreign currency and hedging items! Accordingly, I’m not prepared to say that the ASU will achieve the goal of transparency.

On the other hand, it is pretty easy to explain the *concept* of comprehensive income – all the changes in assets and liabilities other than those that involve transactions with owners. I’m going to make a recommendation on DISPLAY based on something I use in class that seems to

¹ Let me state again that I do not think that the single combined statement of both net income and comprehensive income is necessarily preferred to separate statements. The separate statements have some advantages as discussed in response to Question 6 on earnings per share. I haven’t done a thorough literature review, but I seem to recall that academic research has shown that there is little difference between the separate and combined statements of comprehensive income. There is a difference in effect when subjects receive (or companies produce) the “buried in shareholders’ equity” format. See three papers that come to mind at the end of this letter (I’ve included abstracts).

Teresa P. Gordon

help my graduate students at least figure out if they have the right answer for what they think comprehensive income ought to be. The graphic display is attached as Appendix A. The comparable presentation in the statement of changes in owners' equity would look something like this (based on numbers in revised example 220-10-55-11).

	Common Stock	Additional paid in capital	Accumulated Other Comprehensive Income	Retained Earnings	Total Stockholders' Equity
Beginning balance	150,000	300,000	23,000	88,500	561,500
Comprehensive Income			80,250		80,250
Net income			(63,250)	63,250	-
Common stock issued	50,000	100,000			150,000
Dividends declared				(10,000)	(10,000)
Ending balance	200,000	400,000	40,000	141,750	781,750

With this change in format, the financial statement user will be able to see that it is the *difference* between net income and comprehensive income that changes shareholder equity (via that mysterious AOCI account). The details regarding the components of AOCI are available on either the face of the balance sheet or in a note such as the one illustrated in 220-10-55-15. Personally, I like having the details on the changes during the period in the concise display illustrated in 220-10-55-13. Alternately, one could analyze the proposed detailed display on the face of a combined statement of comprehensive income.

If I am correct in my supposition that most users are interested in net income and likely to be somewhat hazy on why some items are reported as OCI, I would suggest that less detail on the statement of comprehensive income would be a better display. Those who want the nitty-gritty details could then find the detail in the notes. If the FASB and IASB are trying to educate users, then forcing the complete details (including tax effect) onto the single "operating" statement might make sense. However, I think the addition of details should wait until users demand that it be prominently displayed. In the meantime, let companies decide whether to report a single line for "gains and losses not reported in net income (see note X)" or with all the detail the company believes people need. If we could continue to report net income and comprehensive income separately, the details would be appropriate for the face of the separate statement of comprehensive income. See also comments below on the display of reclassification adjustments.

Question 2: Do you agree that the option should continue to report the tax effect for each component of other comprehensive income either in the statement of comprehensive income or in the notes to the financial statements?

The total tax effect needs to be disclosed somewhere – either on the face of the statement or in the notes. I think my preference would be to leave the details in the notes for those users who have a need for the information. I'm not one of the users who find utility in the tax details since

the items may not have a “real” tax effect for many years into the future.[However, if we can do a separate statement of comprehensive income in addition to a statement of net income, reporting the taxes on the face of the statement would probably be appropriate.]

Question 3: Do you believe that a requirement to display reclassification adjustments for each component of other comprehensive income in both net income and other comprehensive income in the statement of comprehensive income would improve the understandability and comparability of financial statements?

Let’s think about some of the reclassifications. First, there is amortization of prior service cost and accumulated actuarial gains and losses. The amounts reported in net income and subsequently “taken out” of comprehensive income are shown pretty clearly in the required notes to the financial statements (in this case, the detail is in the pension note). I cannot imagine that even the proposed new income statement format would be detailed enough to show these relatively minor amounts in the presentation of net income. Accordingly, I can’t see much value arising from placement on the face of the combined income statement TWICE – no value added. The second reclassification item that comes to mind is related to available for sale securities actually sold during the year. The net impact (before taxes) on AOCI is the change in the “allowance” account that adjusts historical cost to fair value. The computation of the actual holding gain or loss during the period is fairly complex because one has to gather information on all the securities purchased and sold during the year. One can “guess” at the holding gain/loss since you either add or subtract the realized gain/loss from the change in the allowance account – a 50/50 chance of getting it right! Starting with an example I use for teaching purposes, I created a spreadsheet so that I could play around with the issue (Appendix B). In all cases, the impact on comprehensive income is related to the change in the allowance account and the impact on net income is the realized gain or loss. The reclassification display is just icing on the cake and does not affect net income or comprehensive income. I guess I’d say the reclassification information is “interesting” but not really necessary. The holding gain or loss might tell me how well a company managed its portfolio but the bottom-line does not change. I’m just do not see a lot of value in the reclassification disclosures.

Question 4: What costs, if any, will a reporting entity incur as a result of the proposed changes?

I would expect the out-of-pocket cost to be minimal since there is no additional information disclosure being required. The FASB is simply asking that the currently disclosed information be displayed in a standard format. However, I suspect the (learning) cost to the users might be high since there are relatively few companies that have chosen reporting formats that give the same prominence to comprehensive income as we give to net income - the current “bottom line.” See related comments below with respect to earnings per share.

Teresa P. Gordon

Question 5: The Board plans to align the proposed effective date of the amendments in this proposed Update with the effective date of the amendments in the proposed Update on financial instruments. Are there any significant operational issues that the Board needs to understand to determine the appropriate effective date for the amendments in this proposed Update?

It seems to me that there is no need to wait for the financial instrument topic to be finalized. The ED on financial instruments is excessively complex and I don't yet feel I have a handle on the details. However, it would appear that there would be one less component of OCI than we currently have (gain/loss on available for sale investments would go away) but new components would be introduced (changes in fair value of financial instruments). I think users would benefit from standardized formats whatever the specific outcome of the financial instruments project.

Question 6: The amendments in this proposed Update would not change the guidance on the calculation and display of earnings per share. Do you believe that the Board should change the guidance on earnings per share? If so, what changes would you recommend and why?

I see no proposed change to the requirement that earnings per share (EPS) be reported on the face of the "income statement." Since there is an apparent prohibition against reporting comprehensive income per share with that level of prominence (ASC 260-10-45-5 implies one could report CI/share in the notes), we will have a confusing display on the combined income statement. Using the ED combined format, the information used to compute EPS (components of net income) will be further removed from the related ratios. I imagine we will become accustomed to skipping over the OCI details if we are most interested in net income. I am not aware of any upswelling demand from users for the reporting of comprehensive income per share. It may arise naturally as users become familiar with the new format. At this point in time, adding another version of EPS to the multiple basic and diluted figures reported would be more confusing than helpful. Obviously, for companies with a simple capital structure and no "components of net income" other than net income from continuing operations, there would be plenty of room for another version of EPS on the face of the combined format. However, the addition of TWO more versions of EPS is possible for a company with discontinued operations and a complex capital structure. Accordingly, the EPS display could get pretty lengthy and potentially confusing. This is another reason for permitting the separate statements – EPS would be reported on the statement of net income and there would be no per share figures on the statement of comprehensive income.

Until we reach the point in time when financial statement users demand the reporting of comprehensive income per share, let's not add further complexity to the basic required statements. To avoid confusion, it seems reasonable to accept a "less detailed" display of the components of OCI if the combined statement becomes mandatory. If we can continue to have separate statements, the statement of net income would display net income per share. When financial analysts routinely choose to report and use CI/share, it will be time to make it displayed on the face of the financial statement.

Impact on not-for-profit financial statements

Not-for-profit entities essentially report “comprehensive income” under existing GAAP, partly because all investments are reported at fair value and the use of derivatives for hedging is relatively uncommon. In other words, components of OCI are rare with the possible exception of the ones related to retiree benefits. When FASB made the changes to pension accounting that forced the reporting of the net asset or liability position onto the balance sheet, not-for-profit entities were directed to separately report the resulting OCI components. In other words, donors are interested in the reporting of functional expenses. We want to know how much of every dollar spent (on average) goes to mission-related activities rather than overhead like fundraising. I cannot think of any component of OCI that could readily be classified as program, fundraising or “management and general” (the three basic functions reported). The larger not-for-profit entities like colleges and universities use an optional display for the statement of activities that adds an “operating income” line similar to that required for health care entities. The OCI components can then be reported as “nonoperating” and this avoids the problem of allocating them among the functional expense categories. What worries me is the impact of the financial instruments project. Will we be creating additional OCI items that will be common in the not-for-profit sector? Many charities take out mortgages to buy or build facilities. The financial instruments ED is for all entities so any charity with a mortgage would face a dilemma: (1) report the asset at cost and the related liability at fair value and then hide the relatively meaningless gains and losses in revenues and hope the total isn’t big enough to draw donors attention, (2) switch to a format with an “intermediate” measure of operations so that the gain or loss can be reported as nonoperating, or (3) choose (if they qualify) the no “mismatch” option and continue to report the liability at amortized cost. I am not asking the FASB to take any particular action at this point in time. Instead, I am pointing out a consequence of the proliferation of components of OCI. They are “strange” and hard to explain amounts that not-for-profit entities will be forced to report. We need to establish meaningful financial statement display formats to enhance (or at least maintain) the usefulness of not-for-profit financial reporting.

Conclusion

In summary, my principal recommendations include: (1) Eliminate the “hidden in stockholders equity” format for reporting comprehensive income. (2) Permit separate statements for net income and comprehensive income. If this option is available, the separate statement of comprehensive income would be a good place to report the details on all components of OCI. If a company prefers the combined format “(net & comprehensive) income statement,” I’d prefer to see less detail on the face of the statement with the details on the components of OCI in the notes. (3) Do not permit or require the reporting of per share comprehensive income figures on the face of a combined format income statement. (4) Consider using the illustration provided for the statement of changes in owners’ equity because it is easy to explain comprehensive income as a concept but hard to explain the components of “other comprehensive income.” We need to make it obvious that AOCI “happens” because there is a difference between comprehensive income and net income. (4) Let users who want all the details on OCI have it – location on face of statement or in notes is not an important issue. Comprehensive income has been reported for years now and I’m still not seeing financial analysts highlight it in their advice to me as an

Teresa P. Gordon

investor. A long time ago, I learned that the old saying was true: You can lead a horse to water but you can't make him drink. Let's give water to those who want it and not just get everyone wet because we think they ought to be paying attention to comprehensive income instead of net income.

Sincerely,

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References with abstracts

Hirst, D. E. and P. E. Hopkins. 1998. Comprehensive income reporting and analysts' valuation judgments. *Journal of Accounting Research* (Vol. 36) 47-83.

The article examines whether clear reporting of comprehensive income (CI) and its components facilitates detection of earnings management by buy-side financial analysts affects their common stock price judgments. It is explained that financial reporting standards allow companies considerable flexibility in determining which accounts are aggregated into the individual line items in the primary financial statements. The article investigates whether two types of CI display, income statement (IS) and statement of changes in equity (SCE), affect the judgments of buy-side equity analysts when they estimate the stock price of a company that upwardly manages its net *income* through its available-for-sale marketable securities portfolio.

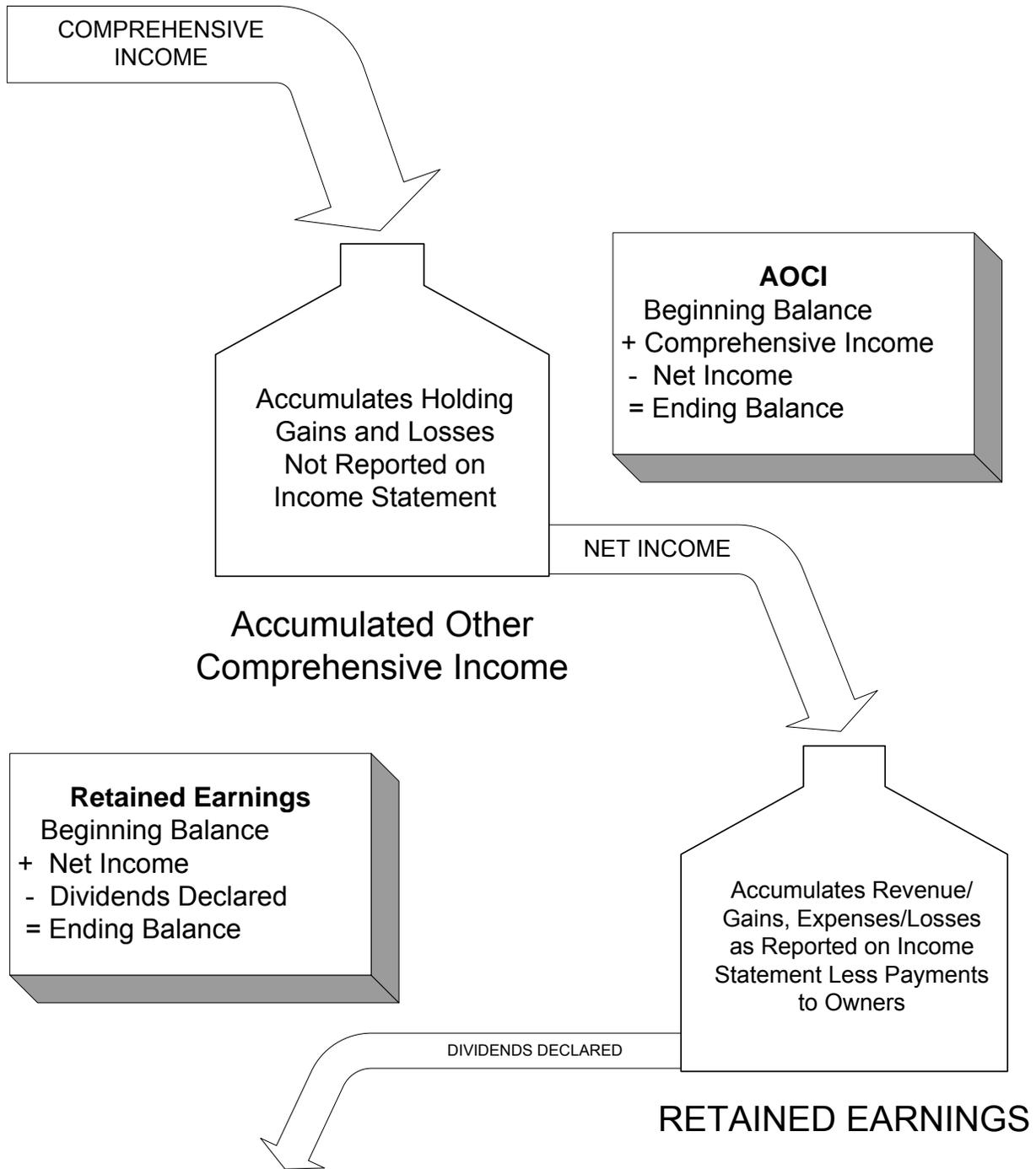
Lee, Y.-J., K. R. Petroni and M. I. N. Shen. 2006. Cherry Picking, Disclosure Quality, and Comprehensive Income Reporting Choices: The Case of Property-Liability Insurers. *Contemporary Accounting Research* (Vol. 23) 655-692.

Statement of Financial Accounting Standards No. 130: Reporting *Comprehensive Income* encourages enterprises to report *comprehensive income* on a performance statement rather than on a statement of equity. We investigate the reporting decisions of 82 publicly traded property-liability insurers that are fairly evenly split in their choice. Our results demonstrate that insurers with a tendency to manage earnings through realized securities' gains and losses (that is, cherry pickers), as well as insurers with a reputation for poor disclosure quality, are more likely to report *comprehensive income* in a statement of equity. Apparently, these insurers face the highest cost of transparency. We do not find a relation between the reporting decision and the volatility of *comprehensive income* relative to the volatility of net *income*. Our findings that insurers' *comprehensive income* reporting choices are a reflection of their proclivity toward cherry picking as well as their level of disclosure quality should be of interest to standard-setters because of the controversy over standard-setters' preference for mandating all firms to report *comprehensive income* in a performance statement.

Maines, L., and L. McDaniel. 2000. Effects of comprehensive-income characteristics on nonprofessional investors' judgments: The role of financial statement presentation format. *The Accounting Review* 75 (2): 179–207.

ABSTRACT: Statement of Financial Accounting Standards (SFAS) No. 130 requires companies to report *comprehensive income* in a primary financial statement, but allows its presentation in either a statement of *comprehensive income* or a statement of stockholders' equity (Financial Accounting Standards Board [FASB] 1997). In an experiment, we examine whether and how alternative presentation formats affect nonprofessional investors' processing of *comprehensive-income* information, specifically, information disclosing the volatility of unrealized gains on available-for-sale marketable securities. The results show that nonprofessional investors' judgments of corporate and management performance reflect the volatility of *comprehensive income* only when it is presented in a statement of *comprehensive income*. We provide evidence consistent with our psychology-based framework that these findings occur because format affects how nonprofessional investors weight *comprehensive-income* information and not whether they acquire this information or how they evaluate it.

Appendix A
A Visual Aid to Explaining how AOCI works



Appendix B – Example to Illustrate Computations of Holding Gain or Loss

FACTS for example - change only the shaded cells			
Portfolio of available for sale securities	12/31/X1	12/31/X0	
Historical cost	648	661	
Allowance Account to adjust to market value	279	1,279	
Fair value reported on balance sheet	927	1,940	
Securities sold during year at selling price	190		
Basis of securities sold during year	225		
Realized loss reported on income statement	(35)	0	
Summary of available for sale transactions	Cost	Allowance	Fair value
Beginning balance 12/31/X0	661	1,279	1,940
Securities purchased	212		212
Basis of securities sold	(225)		(225)
Adjust ending portfolio to fair value		(1,000)	(1,000)
Ending balance 12/31/X1	648	279	927
Statement of Comprehensive Income		20X1	20X0
Net income (in thousands)		\$2,500	\$2,600
Total holding (loss)/gain on securities*		(\$1,035)	\$578
Less reclassification adjustment for losses included in net income		(35)	
Other comprehensive income, before tax		(1,000)	\$578
Less Income tax expense		(\$200)	\$116
Other comprehensive income, net of tax		(\$800)	\$462
Comprehensive income		\$1,700	\$3,062
<u>*The holding gain or loss can be computed as follows:</u>			
Portfolio value as reported at 12/31/X1			927
Add selling price of securities sold during period			190
1. Adjusted ending fair value			1,117
Portfolio value as reported at 12/31/X0			1,940
Add purchase price of securities acquired during period			212
2. Adjusted beginning fair value			2,152
3. Adjusted ending minus adjusted beginning = holding loss for the period to be reported on statement of comprehensive income			(1,035)

Changes to shaded cells in Excel will produce “results” to examine impact of reclassification adjustment