



## **AMERICAN ACCOUNTING ASSOCIATION**

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#### **Response to the FASB's Exposure Draft – “Comprehensive Income (Topic 220)”**

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#### **INTRODUCTION**

The Financial Accounting and Reporting Section of the American Accounting Association has charged the Financial Reporting Policy Committee (the Committee) with responding to requests for comment from standard setters on issues related to financial reporting. The Committee is pleased to respond to the Financial Accounting Standards Board (FASB) Exposure Draft, *Comprehensive Income (Topic 220)* (hereafter the ED) issued in May 26, 2010. The opinions in this letter reflect the views of the individuals on the Committee and not those of the American Accounting Association or the Financial Accounting and Reporting Section.

The ED proposes to simplify the reporting of comprehensive income by eliminating display options. The primary change is to eliminate options to report other comprehensive income (OCI) as a separate statement (beginning with net income) or within a statement of changes in equity. Instead, comprehensive income would be reported in a continuous statement that includes (i) components of net income and (ii) components of OCI. The objective of the changes to financial reporting is to increase transparency, consistency and comparability of

amounts reported as net income and OCI under both US GAAP and International Financial Reporting Standards (IFRS).

## **OVERALL EVALUATION**

The Committee wholeheartedly supports the move to a simplification of the reporting of comprehensive income in a single continuous statement. We believe that the current options available have led to persistent confusion by investors about components of OCI and have permitted manipulative disclosure practices by managers that exacerbate the ability of users to properly impound information about OCI into their analyses. Further, the coordination between the FASB and International Accounting Standards Board (IASB) will help with the larger objective of increasing the comparability of financial statements. We do, however, have objections to several proposals pertaining to gross vs. net of tax reporting and the lack of a requirement to report comprehensive income per share.

## **ENUMERATED 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?*

We agree that requiring a continuous statement of comprehensive income will improve comparability, transparency, and to some degree, understandability of the financial statements. Herein we describe potential benefits and costs of requiring a continuous statement. Where possible we incorporate accounting research on comprehensive income.

There are many benefits to a continuous statement. By construction, the elimination of alternate treatment options will increase the comparability of financial statements across firms. Moreover, by requiring the effects of OCI to be included as part of a single statement of performance, total comprehensive income better reflects actual changes in the firm's net assets and results in a cleaner articulation between the income statement, balance sheet, and statement of cash flows to increase transparency (e.g., See the earlier comment letter prepared for the original standard on comprehensive income; FASC 1997).

Accounting research supports the need for this increase in transparency, as both archival and experimental studies find that managers appear to utilize the sale of available-for-sale securities to manipulate income (by realizing previously unrealized gains or losses) and exhibit a greater tendency to report OCI in the statement of equity. Under the perspective that components of the formal statement of income are more transparent than those in a separate statement of equity, this reduces the likelihood of investors recognizing that the change in the security's value had changed net assets in an earlier reporting period (e.g., Hunton et al. 2006; Lee et al. 2006; Bamber et al. 2010). For example, Lee et al. (2006) find that managers strategically sell specific available-for-sale securities to recognize a particular gain or loss (cherry-picking), and that these managers are more likely to opt to report OCI in the statement of equity in an attempt to obscure this behavior.<sup>1</sup> In an experimental setting, Hunton et al. (2006) find a reduction in earnings management when managers are required to report total comprehensive income in a continuous statement.

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<sup>1</sup> Hirst and Hopkins (1998, 2000) find that analysts are misled by this earnings management. Specifically, analysts' stock price judgments are significantly higher when a company with no growth in core earnings maintains steady growth in reported net income by selling—and subsequently repurchasing—previously appreciated available-for-sale securities. Moreover, they find that clear income-statement display of comprehensive income and its components improves analysts' valuation judgments, further supporting the proposed change to require a single statement of comprehensive income.

Finally, with respect to understandability, Maines and McDaniel (2000) find that non-professional investors acquire information regarding the volatility of unrealized gains regardless of their placement, but only impound this information when OCI is reported within the single statement of comprehensive income (versus a statement of equity). The authors suggest that investors rely on the placement within the financial statements to provide signals about the nature and importance of the comprehensive income components. Because studies examining the determinants of the placement of OCI find it is more associated with earnings management (e.g., Lee et al. 2006) or equity incentives and career concerns (e.g., Bamber et al. 2010) than the importance of the transactions to the firm, this further supports the requirement of a single statement of comprehensive income.

In the comment letters pertaining to the prior exposure draft, the main projected cost of requiring a single statement was an increase in the perceived volatility of earnings or cash flows (Yen et al. 2007), as components of OCI are inherently more volatile than components of net income (see, for example, Figure 1 of Bamber et al. 2010). Since the prior exposure draft, several studies have investigated the merits of this concern, and the general consensus is that investors do perceive earnings of firms to be more volatile when comprehensive income is reported in a single statement. However, we are not aware of any studies evaluating whether the increased in perceived volatility exceeds the “appropriate” level. As noted above, Maines and McDaniel (2000) find that non-professional investors only weight the volatility associated with unrealized gains and losses from available-for-sale securities when comprehensive income and its components are included in a single statement of comprehensive income, and Hirst and Hopkins (1998; 2000) find a similar result for analysts—that these professional market participants fail to acquire and incorporate the unrealized gain or loss information when it is

disclosed in the equity statement, but do acquire and use this information when it is presented in a single statement of comprehensive income. Several studies also examine manager behavior, and conclude that managers behave as if they understand that market participants do not fully impound OCI information that is presented in a separate statement. Specifically, as noted above, managers suspected of managing earnings using the strategic sale of available-for-sale securities are more likely to report OCI in a separate statement, and Bamber et al. (2010) find that managers with incentives to reduce perceived volatility (with equity incentives or career concerns) are also more likely to report OCI in a separate statement.

To summarize, we are in favor of the single-statement requirement. We feel that the proposed change will increase both comparability and transparency, where the increased transparency might be expected to reduce earnings management via the strategic selling of available-for-sale securities, for example. With respect to understandability, consistent with concerns of increased perceived volatility, there is some evidence that investors only weight the volatility in OCI when it is presented in the statement of comprehensive income. We are not aware of any research, however, that concludes that investors “over-weight” volatility; rather, it seems that investors and analysts underweight this information when it is disclosed in a separate statement (e.g., Maines and McDaniel 2000; Hirst and Hopkins 1998, 2000).

***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?*

We feel it is important to identify the tax effect for each component of OCI. More importantly, we strongly feel there should not be a choice to report either gross or net OCI, but instead that all firms should be required to report on the same basis (whatever the outcome). We feel that the net basis is the most appropriate for the statement of comprehensive income, and that footnote

disclosure of the gross amounts and tax effects should also be required (as illustrated in 220-10-55-8A of the ED). We believe the net basis is most logical for reporting OCI components for the simple reason that these amounts follow net income, which is net of taxes (as are discontinued operations and extraordinary items).

***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?*

Based on management's proclivity for using comprehensive income to manage earnings (e.g., Lee et al. 2006, Hunton et al. 2006), we feel it is imperative that reclassification adjustments for each component of OCI be reported in the statement of comprehensive income. Based on the above-referenced studies, relegating these disclosures to the footnotes might increase the likelihood of earnings management in the manner discussed above (under Question 1).

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

We are not aware of any implementation costs of the proposed changes.

***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?*

We are not aware of any significant operational issues associated with the proposed changes.

**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?*

We would recommend that an EPS amount for total comprehensive income also be provided for two reasons. First, EPS disclosures are ubiquitous and their use by investors is extensive in tracking the performance of companies. Second, as articulated in FASC (1997), there are numerous benefits to users of financial statements of being provided a summary, comprehensive measure of income that reconciles with the equity account. Thus, the numerous benefits of reporting a comprehensive measure of income compel the disclosure of per share amounts. To cave into arguments about the negative ramifications of the inherent volatility of OCI amounts, and hence comprehensive income, is to confuse the role of financial *reporting* with the role of financial *analysis*. Line item disclosures of profit and loss amounts enable users to parse performance in ways that suit their objectives. We believe that *not* requiring per share disclosures for comprehensive income undermines the overall objective of the standard.

**Other Comments:** We would also like to comment on the convergence with IFRS. The FASB and IASB worked together to develop the proposed amendments to their standards on reporting OCI. Concurrent with the FASB's ED, the IASB issued its Exposure Draft, "Presentation of Items of Other Comprehensive Income." Both the FASB and IASB propose a single continuous statement of comprehensive income, and both allow similar options for presenting tax expense related to OCI (see above response to Question 2). Two differences in proposed presentation appear to exist between the proposals.

The first difference is that the FASB requires reclassification adjustments between net income and OCI to be reported in the statement (i.e., 220-10-45-17 of the ED). The IASB ED

does not directly address where to report reclassification adjustments but appears also to allow disclosure of the reclassification adjustments in the notes (See footnote (b) of the illustration on page 16 of the IASB proposal). We suggest the Boards come to an agreement as to where to present these adjustments, so as to minimize unnecessary impediments to comparability across financial reporting jurisdictions.

The second difference is that the IASB proposal further classifies OCI into (i) items that might be reclassified to profit or loss in subsequent periods; and (ii) items that will not be reclassified subsequently to profit or loss (see paragraph BC7 of the IASB proposal). This difference is due to certain items under IFRS never being reported through net income, such as the option to report all pension related actuarial gains or losses in OCI. As such, this difference appears to be a result of the differences in other accounting and reporting requirements in other standards, rather than a presentation issue alone. Therefore, we suggest as the Boards continue their convergence process, the accounting and reporting for items in these other standards that relate to OCI be considered for convergence. Nonetheless, the current ED moves in the direction of increased comparability of US GAAP and IFRS.

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