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# Comprehensive Income Reporting: FASB Decides Location Matters

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# Comprehensive Income Reporting: FASB Decides Location Matters

By Dennis J. Chambers

It is often said that the three most important qualities in real estate are "location, location, location." Now it seems the same may be said for comprehensive income reporting. On June 16, 2011, FASB issued Accounting Standards Update (ASU) 2011-05, *Presentation of Comprehensive Income*. This new accounting standard requires that all companies report comprehensive income in an income statement–type location. Prior to ASU 2011-05, companies had the option of reporting comprehensive income in the statement of changes in equity. While some companies' reporting already complies with the new standard, most public companies will have to significantly change where they report comprehensive income.

## Prior Reporting Requirements

Since the release of Statement of Financial Accounting Standards (SFAS) 130, *Reporting Comprehensive Income*, FASB has permitted companies to report comprehensive income in a variety of formats and locations. The prior standard, now found in Accounting Standards Codification (ASC) section 220, provided examples of reporting in three different locations:

- In a single statement of financial performance including the components of net income and other comprehensive income,
- In a separate statement of comprehensive income starting with net income, and
- In the statement of changes in equity.

While the prior standard did not require a particular reporting location, FASB stated a preference for reporting comprehensive income in an income statement–type format like the first two alternatives. ASC section 220-10-45-10 states: "Displaying comprehensive income in an income statement–type format is superior to displaying it in a statement of changes in equity." Contrary to this preference, studies have found that the vast majority of public companies (approximately 80%) report comprehensive income in a statement of changes in equity.

## Reporting Requirements Under the New Standard

ASU 2011-05 requires companies to report total comprehensive income and its components either in a single continuous statement of comprehensive income or in two separate, but consecutive, statements of net income and other comprehensive income. The single continuous statement should be displayed in two parts: net income and other comprehensive income, with totals for each part. Alternatively, if two consecutive statements are used, the first statement would be the traditional income statement and the second statement would be a statement of comprehensive income that begins with net income. Under both alternatives, companies must now report total comprehensive income in an income statement–type location. Hypothetical examples of each format permitted under the requirements of the new accounting standard are shown in *Exhibit 1* (single continuous statement) and *Exhibit 2* (separate consecutive statements).

The International Accounting Standards Board (IASB) has also issued guidance that allows these same two alternative reporting formats. The reporting guidance under U.S. GAAP and International Financial Reporting Standards (IFRS) has essentially converged, but there are still differences between U.S. GAAP and IFRS with regard to what is included in comprehensive income and in reclassification requirements.

## Is Income Statement–Type Reporting Really Better?

FASB has long argued that other comprehensive income is best reported as part of total comprehensive income in an income statement–type format, rather than as part of the statement of changes in equity. FASB claims that this preferred reporting location provides greater transparency, comparability, and consistency. Interestingly, these assertions are generally not accompanied by any supporting arguments or evidence. Several academic studies, however, shed light on the relative merits of alternative comprehensive income reporting locations.

The first such study was conducted by D. Eric Hirst and Patrick Hopkins ("Comprehensive Income Reporting and Analysts' Valuation Judgments," *Journal of Accounting Research*, vol. 36, supp., 1998, pp. 47–75). Based on research in psychology, they argued that the availability and clarity of reported financial accounting information affects the ability of financial statement users to process that information. This may seem like a rather unsurprising argument, but finance theory would argue the opposite—that is, that the location and format of financial information is irrelevant in a world of efficient markets.

Hirst and Hopkins performed experiments with professional buy-side analysts in which the participants were asked to value a hypothetical company. The financial statements of the company contained comprehensive income information revealing that the company actively manages earnings by selective sales of available-for-sale (AFS) marketable securities. AFS securities are reported at fair value on the balance sheet, and unrealized gains and losses are reported as a component of other comprehensive income. Therefore, by selectively selling or holding stocks in their AFS portfolio, companies can manage reported net income. (This kind of earnings management is often called "cherry picking.")

Some of the participants were given financial statements in which comprehensive income was reported in an income statement–type format that included the components of net income and other comprehensive income. This location is consistent with the new accounting standard. Other participants were given financial statements in which other comprehensive income was reported in the statement of changes in equity. This location is consistent with prior practice. Hirst and Hopkins hypothesized that the participants given the income statement–type format, being purportedly more available and clear, would be better able to detect the use of earnings management and would appropriately devalue those earnings.

Consistent with their hypothesis, they found that analyst participants more easily detected the earnings management when viewing comprehensive income in the income statement–type format, as compared to when viewing it in the statement of changes in equity. In fact, analysts given the income statement–type format successfully discounted the managed portion of earnings and valued the company the same as a company that did not manage earnings. Therefore, the results of Hirst and Hopkins' research support FASB's asser-

**EXHIBIT 1**
Hypothetical Single-Continuous Statement

**ABC Corporation**
**Statement of Comprehensive Income**
**Year Ended December 31, 20XX**

| | | |
|---|---|---|
| Revenue | | $ 259,400 |
| Cost of goods sold | | 163,422 |
| Gross profit | | 95,978 |
| | | |
| Operating expenses: | | |
| Selling expenses | $ 28,534 | |
| General and administrative expenses | 38,910 | 67,444 |
| Operating income | | 28,534 |
| Other revenues and gains: | | |
| Gain on sale of securities | | 5,188 |
| Other expenses and losses: | | |
| Interest expense | | (6,226) |
| Net income before tax | | 27,496 |
| Income tax expense | | (8,249) |
| Net income | | 19,247 |
| | | |
| Other comprehensive income, net of tax: | | |
| Foreign currency translation adjustments (net of $4,780 tax)[1] | | 11,154 |
| Unrealized gain on sale of available-for-sale securities: | | |
| Unrealized gains during the period (net of $1,779 tax) | 4,150 | |
| Less: reclassification adjustment for gains included in net income (net of $1,334 tax benefit) | (3,113) | 1,037 |
| Unrealized loss on derivatives (net of $2,334 tax benefit) | | (5,447) |
| Other comprehensive income | | 6,744 |
| | | |
| Comprehensive income | | $ 25,991 |

1. Alternatively, other comprehensive income components can be reported gross of tax, with one amount shown for the effect of income tax. In that case, a note should provide an allocation of the tax effects for each of the other comprehensive income components.

tions that their preferred reporting location is more transparent.

The second study, by Laureen Maines and Linda McDaniel ("Effects of Comprehensive-Income Characteristics on Nonprofessional Investors' Judgments: The Role of Financial-Statement Presentation Format," *Accounting Review*, vol. 75, no. 2, 2000, pp. 179–207), examined the question of reporting location using nonprofessional experimental participants. Maines and McDaniel predicted that reporting location would have little effect on the acquisition of comprehensive income information, but would have a significant effect on the relative importance nonprofessional investors give to that information in their estimates of company performance; the more performance-related income statement–type format should lead to greater weight being given to comprehensive income information.

In their experiment, Maines and McDaniel randomly provided 95 evening MBA students (with an average of almost six years of investment experience) with several different presentation locations, including the income statement–type format and the statement of changes in equity. The hypothetical financial statement information revealed the volatility of the company's unrealized AFS security gains and losses. As they predicted, there was little difference in the participants' ability to find this information regardless of the reporting location. However, there was a significant difference in the weight given to the volatility information, with participants giving more weight when comprehensive income was reported in the income statement–type format. This fact, plus the results of Hirst and Hopkins discussed above, supports FASB's assertions that the income statement–type format is more transparent.

Both studies were conducted before companies actually began reporting comprehensive income under the requirements of SFAS 130. Before SFAS 130 became effective in 1998, companies were not required to report other comprehensive income or its components in any financial statement. Therefore, the professional analysts and nonprofessional investors who participated in those studies had no experience finding or interpreting other comprehensive income reported in financial statements of actual companies. More significantly, under SFAS 130, the vast majority of companies choose to report other comprehensive income in the statement of changes in equity. Therefore, those experimental results might have been different if participants had gained experience finding and analyzing other comprehensive income in its most common reporting location.

A final study, by Dennis Chambers, Thomas Linsmeier, Cathy Shakespeare, and Theodore Sougiannis ("An Evaluation of SFAS No. 130 Comprehensive Income Disclosures," *Review of Accounting Studies*, vol. 12, 2007, pp. 557–593), used a very different methodology to address the question of reporting location. Rather than using experimental subjects, they used actual market prices and reported financial statement information. They examined how stock-price returns for Standard & Poor's 500 Index companies were affected by comprehensive income–reporting location. The study sample covered the four-year period after the implementation of SFAS 130 (1998–2001). During this period, market participants had experience with actual comprehensive income disclosures; the vast majority were reported in the statement of changes in equity.

**EXHIBIT 2**
Hypothetical Two Separate but Consecutive Statements

**ABC Corporation**
**Statement of Income**
**Year Ended December 31, 20XX**

| | | |
|---|---|---|
| Revenue | | $ 259,400 |
| Cost of goods sold | | 163,422 |
| Gross profit | | 95,978 |
| | | |
| Operating expenses: | | |
| Selling expenses | $ 28,534 | |
| General and administrative expenses | 38,910 | 67,444 |
| Operating income | | 28,534 |
| Other revenues and gains: | | |
| Gain on sale of securities | | 5,188 |
| Other expenses and losses: | | |
| Interest expense | | (6,226) |
| Net income before tax | | 27,496 |
| Income tax expense | | (8,249) |
| Net income | | 19,247 |

**ABC Corporation**
**Statement of Comprehensive Income**
**Year Ended December 31, 20XX**

| | | |
|---|---|---|
| Net income | | 19,247 |
| Other comprehensive income, net of tax: | | |
| Foreign currency translation adjustments (net of $4,780 tax) | | 11,154 |
| Unrealized gain on sale of available-for-sale securities: | | |
| Unrealized gains during the period (net of $1,779 tax) | 4,150 | |
| Less: reclassification adjustment for gains included in net income (net of $1,334 tax benefit) | (3,113) | 1,037 |
| Unrealized loss on derivatives (net of $2,334 tax benefit) | | (5,447) |
| Other comprehensive income | | 6,744 |
| | | |
| Comprehensive income | | $ 25,991 |

The study found evidence that other comprehensive income information is included in stock-price returns when it is disclosed in the statement of changes in equity. However, Chambers et al. found only limited evidence that the information is included in stock price returns when reported in an income statement–type format. This result is inconsistent with FASB's assertion that the income statement–type format is inherently more transparent and understandable for investors; alternatively, it is consistent with investors adapting to the more predominant choice made by public companies under SFAS 130 to report other comprehensive income in the statement of changes in equity.

### Location Matters

These three studies provide important insights into the need for and the usefulness of FASB's new comprehensive income reporting requirement. The Chambers et al. study demonstrates that the currently predominant reporting location in the statement of changes in equity has not prevented investors from finding and using the information. Nevertheless, their results also imply that investors will adapt to whatever location becomes the predominant one, including the income statement–type format mandated by ASU 2011-05. In addition, the two studies by Hirst and Hopkins and by Maines and McDaniel provide evidence that the income statement–type format provides the most accessible and interpretable location, particularly for inexperienced investors not accustomed to a particular reporting location.

Overall, two of the three studies provide support for FASB's position that reporting comprehensive income in an income statement–type location results in greater transparency, comparability, and consistency. In that sense, as in real estate, the location of comprehensive income reporting is important. The third study, while not supporting FASB's position, does support the idea that future financial statement users will adapt to whatever reporting location FASB requires. ❑

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## IMPLEMENTING ASU 2011-05

The changes mandated by Accounting Standards Update (ASU) 2011-05 deal with the manner and location of the reporting of other comprehensive income. ASU 2011-05 is effective for all public companies in fiscal years beginning after December 15, 2011; the effective date for nonpublic companies is December 15, 2012. Once effective, all companies must report other comprehensive income in either a continuous income statement–type statement of comprehensive income that includes both net income and other comprehensive income, or in two consecutive statements of income and comprehensive income. The current practice of the vast majority of public companies is to report this information in the statement of changes in equity; ASU 2011-05 will no longer permit this form of reporting.

Two accompanying hypothetical examples illustrate the permitted formats mandated by ASU 2011-05. The first hypothetical example, demonstrating the single continuous statement format, consists of two parts. The first part contains the components that have previously been reported in the income statement. The second part reports the components of other comprehensive income. The second hypothetical example demonstrates the alternative two-statement format. This format includes a statement of income, followed immediately by a statement of comprehensive income that begins with net income. Under both formats, each component of other comprehensive income can be reported either before tax (with the total tax effect reported as a separate component) or net of tax. The tax effect for each component must either be disclosed parenthetically (as shown in the Exhibits) or in a note to the financial statements.

The changes mandated by the new standard are strictly limited to the location and manner of reporting. It makes no change in the types of items to be included in other comprehensive income. These include foreign currency translation adjustments, gains and losses on foreign currency transactions related to effective hedges, gains and losses on long-term intra-entity foreign currency transactions, gains and losses on cash flow hedge derivative instruments, unrealized gains and losses on available-for-sale securities, and a number of items related to pensions and other postretirement benefits. ASU 2011-05 does not make any changes in the way earnings per share is calculated and reported, nor in the way components of other comprehensive income are reclassified to net income.

As with all changes in accounting principle, the transition to the new reporting format should be based on ASC section 250-10, *Accounting Changes and Error Corrections*. Specifically, ASC section 250-10-45-5 spells out the requirements for the "retrospective application" of changes in accounting principle. Retrospective application generally has three components:

- Reported comparative financial statements (usually showing the current and two prior fiscal years) should reflect the period-specific effects of applying the new accounting principle in those periods.
- An adjustment should be made to the carrying amounts of assets and liabilities to reflect the cumulative effect of the new standard on prior periods.
- Any offsetting adjustment should be made to the opening balance of retained earnings or other appropriate equity components.

Again, ASU 2011-05 only changes the reporting format and location of other comprehensive income, not its measurement or recognition. Because there are no cumulative effects to any asset, liability, or equity accounts, only the first retrospective requirement will apply upon the adoption of ASU 2011-05. Companies adopting ASU 2011-05 for the first time must report financial statements comparing current and prior fiscal years using one of the newly required income statement–type reporting formats for comprehensive income.