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Comprehensive income, a new dimension in performance measurement and reporting

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Abstract

This paper addresses the comprehensive income in terms of the concept of calculation, reporting, relevance, its relationship to the net income. Study methodology is based on critical analysis of literature and the empirical researches regarding comprehensive income and its consequences on financial reporting. The findings confirm that both net income and comprehensive income are useful in measuring the performance of a company. This paper can be a useful material for other future studies on deepening the concept of comprehensive income.

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Keywords: Comprehensive income; net income; IFRS; relevance.

1. Introduction

The image of the accounting truth is associated with accurate and precise statements, without errors without bias and hesitation. But we can not speak of "truth" in general but only in the specific manner. When asked “What is the most relevant measure of performance?“, the theoretical and empirical specialised literature found approaches and explanations that are far from eliminating the current concerns to provide answers as adequate as possible to this highly controversial concept.

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Performance should be measured and reported as information relevant for the financial statement users, which means that this concept is part of all paradigms known by the accountancy in its evolution from the technique, art of accounting records, information tool and social intermediation tool.

This paper aims to determine the relevance of the comprehensive income for assessment as well as its predictive capacity in determining profitability, of the expected cash flows.

The research methodology consists of the critical review of the specialized literature on the importance of the comprehensive income in assessment and forecast, compared with the net income. The documentation results reveal that there are both followers and critics of the comprehensive income, often tilting the balance in favour of the net income, especially in respect of the latter's predictive ability.

2. Performance is assessed differently depending on the interests of the financial statement users

The offer of information on the company performance is one of the important objectives of the financial statements in order to meet the requirements of a wide range of users in making economic decisions.

Managers are interested in the overall performance, while investors are interested in the profitability of the investments, and creditors in the solvency of the company.

From a historical perspective, the concept of accounting result is perceived differently compared to the concept of economic results.

Basu (1997) created a model by which it predicts the correlation between returns and accounting profit when the future economic performance is likely to deteriorate (periods of adverse information) or to appreciate (periods of favourable information). The accounting profit is operationalized with the net profit for the accounting period reported in the profit and loss account and the economic profit is reflected through the market return construction calculated based on the price of the securities. Thus, Basu manages to defuse the tension between the two known economic categories in relation to the profit resulting in the increase of the informational efficiency.

The General Accounting Framework sees profit as a performance measure or as a reference basis for the calculation of certain indicators, such as return on investment or earnings per share. Profit is assessed from the perspective of the income and expense items which in turn partly depend on the concepts of capital and capital maintenance.

In the accounting concept, we find the following definitions for result:

a) incomes are increases in the economic benefits recorded throughout the accounting period as inflows or increases in assets or decreases of debts resulting in increases of equity capital, other than those related to contributions from equity capital participants.

b) expenditures are recorded decreases in the economic benefits during the accounting period in the form of outflows or reductions of assets or increases in liabilities that result in decreases in the equity capital other than those related to the distribution to the equity capital participants.

We can see that the conceptual approaches of the results in the opinion of the General Accounting Framework identify all the essential characteristics of the results without specifying the criteria that must be fulfilled in order to be recognized as incomes and expenses.

The accounting conceptual framework distinguishes between actual revenue and earnings though both categories correspond to the definition of income. Actual revenues are generated from ordinary activities of the entity, being known under different names: sales, interest, dividends, royalties and leases.

Earnings are increases in the economic benefits meaning that they have the same nature as the income. These earnings are no obtained from current activities of the company and in compliance with the requirements of the General Accounting Framework they are usually presented separately at the net value without going through the offset relationship between incomes and expenses.

Moreover, losses correspond to the definition of the expenses with the same nature as theirs. Like earnings, losses are recognized and presented separately at the net value, given their importance in the economic decision-making process.

Two main concepts are known concerning performance: the operating income and the “all-inclusive” income. The operating income is generated by the current operations of the business entity, based on the historic cost concept. The follower of the ”all inclusive” concept believe that all the elements influencing the size of capitals

during an financial year, other than the transactions with the owners, are financial performance measurement attributes.

Patton and Hatfield, the theorists on the accurate assessment of the income, advocate using the calculation of the income using the current cost, the only assessment bases that would satisfy the users' information needs. Edwards and Bell propose different income concepts for different purposes. One of these concepts is to anticipate the comprehensive income concept, meaning that proposes measuring profit by taking into account both the current operating costs as well as incomes or losses from holding assets or liabilities.

Chambers (1994) believes that the assessment of the company performance can be achieved with the help of the comprehensive income. In his view, the acquired assets contribute to the company performance not only with the sales margins but also with the expected price changes. Chambers is the supporter of the assessment of assets at the net realizable value.

The validation of theories based on the concept of economic results in the accounting practice of the financial reporting experiences difficulties in since in the cognitive approach new assumptions emerge concerning the importance of the quotations of the securities in assessing the relevance of the accounting information. The theories on the assessment of a income were able to explain or predict the option of the company for a certain accounting policy.

The performance of the company cannot be accurately determined based only on the financial statements, without knowing in detail its accounting policy.

Colasse (1995) believes that the income determined by means of an accounting method from several possible, is not an objective, real income.

Jacques Richard has the same opinion in relation to the concept of result. He believes that the result is a subjective concept because its determination is made according to the privileged users of the financial statements, the assessment policy, the accounting principles related to the accounting system.

The papers written by Ohlsonm and Fetham (1995) on how accounting can create value for the investors and on the links between the market values and the accounting values is a perspective change in the accounting cognitive approach. Basically, the accounting research cyclically returns to what is essential to identify the accounting information that reflects the value of the company.

Yves Bernheim (1998) proposes two methods of determining the income, in order to meet two types of information needs of the users:

- Measuring the performance of the activities carried out in a period by the difference between the incomes and their expenses;
- Measuring enrichment, through patrimonial approach as the difference between the net assets at the end and at the beginning of the analysed period.

The assessment at fair value of the various balance sheet items in accordance with the requirements of several IFRS determined the shift from the accounting income to the comprehensive income.

Integrating latent gains and losses in the company performance implies renouncing the achievement criterion, as a basis of reflecting the performance of the company. Achievement is only the confirmation of the gain. The difference between economic gains and losses generates a number of asymmetries given the heterogeneity of the users of the accounting information from which the shareholder is the privileged one.

Lenders prefer financial statements that reflect economic losses, ignoring the economic gains until they are actually made. On the contrary, shareholders prefer the appropriate recognition of economic gains and losses.

Through the review made within the IASB-FASB convergence programme, by implementing a new financial statement, the comprehensive income statement the question is: Is this review a revolution or a compromise between the priority given to the balance sheet and that given to the profit and loss account? The old dilemma of the conceptual accounting framework to define incomes and gains as balance structures is well-known.

We ask ourselves whether the accounting undergoes a crisis in the context of world recession, concerning the performance assessment and measuring methods. Of course the answer is yes and the allegations against the fair value in the assessment of the financial tools by the representatives of the failing banks certainly require rethinking performance assessment and measuring methods by preserving the "healthy part", by the recognition (even mutual) of the accounting specificity of each country.

We cannot accurately assess the performance of a company based on financial statements as long as we do not know in detail the accounting policy of the business entity that is studied. Performance should not be measured only on the basis of the past and the present data. However, the compliance with the principle of business continuity shows that the future has a crucial role in assessing the ability of the company to be efficient.

The accounting income has lost and tends to lose ground in measuring the financial performance of the company by the emergence of the comprehensive income as a result of shifting from the assessment at historic costs to the assessment at the fair value, or from the abandonment of the concept of income of the past and present period to the concept of performance that includes the future perspective of the company.

At the moment of this paper, accounting researchers have not reached a consensus on the relevance of the information of the comprehensive income and of the impact of the manner of presenting this indicator on the decision-making behaviour of investors on the capital market.

3. Relevance of the comprehensive income

In a period of economic instability, such as the current period, Hodgson and Nechita (2013) believe the lack of forecast information is fully felt which means that the comprehensive income is gaining more ground compared to the traditional accounting income that is limited and helpless in pertinently reflecting company performance.

The critical analysis of the specialised literature identifies three trends related to the assessment of the relevance of the comprehensive income compared to the net income:

- The comprehensive income is more relevant than the net income.

The comprehensive income includes any gains or losses recorded during the year, realized or not. The adoption of the comprehensive income represents a conceptual shift with important consequences for the performance measurement in the financial statements.

In the theoretical case of the evaluation of all balance sheet items at fair value (full fair value accounting), the comprehensive income on share would correspond to the stock exchange variation.

The comprehensive income is a broad measure of the effects of the transactions and other events of an entity, meaning all changes in equity except those resulting from contributions and distributions to owners.

The decisional relevance of comprehensive income is verified by several empirical studies. The comprehensive income is important for the shareholders because it happily combines the operating performance with the income flows generates by the variation of the fair value of the balance sheet items.

The importance of the relevance of “other comprehensive income items” for the assessment of the entity has been the object of many empirical studies in the comprehensive income normalization process.

Barth and Beaver (2001) believe that the comprehensive income is better than the net result in forecasting profitability

The information supplied separately by other comprehensive income items is more important than their aggregate size. Empirical evidence that the comprehensive income is better than the net income in forecasting operating cash flows are highlighted by Biddle and Choi (2006).

Moreover, empirical arguments on the relevance for the assessment of the comprehensive income of the relevant information provided by “other items on the comprehensive income” for the price analyses, are given in 2007, by European researchers Ramond, Casta and Lin (2007).

- The net income is better than the comprehensive income.

On the western stock markets, the “net income” indicator is preferred in assessing the company performance. A review of the specialized literature confirms that the number of the studies that highlight the superiority of the net income compared to the comprehensive income in terms of relevance, forecasting ability, close relationship with the price of the bonds is significant. Beale and Davez (2001) argue that the comprehensive income due to its composition “other comprehensive income items”, may be misleading in measuring performance given the volatility of these items. The net income has a higher forecasting ability than the comprehensive income because it is generated by recurrent operations of the entity.

In his model, Ohlson (1999) reaches the conclusion that the comprehensive result due to its composition “other comprehensive income items”, is not a necessary requirement for the transparent performance assessment.

The only component of the comprehensive income that leads to a direct relationship between the income size and the earning rate is that of the adjustments for tradable shares, which was verified for the investment companies.

Many empirical studies of the American researchers reach the conclusion that the net income dominates the comprehensive income in the forecast of the operating cash flows. In conclusion, based on the above-mentioned studies, the comprehensive income has a low relevance for the company assessment and for the assessment of the company and the forecast of the operating cash flows, compared to the net income. Moreover, the components of the other comprehensive income items are reflected to a reduced extent into the market prices.

We believe that the results of the empirical studies on the superiority of the net result compared to the comprehensive result should not be approached as an absolute truth. The hierarchy of the two concepts must be made considering the relevance of each item included in "other comprehensive income items". For example, the revaluations of the financial securities owned for sale are strongly correlated to the prices of the securities while the revaluations of the intangible and tangible assets rarely convey relevant information.

- The net income and the comprehensive income are equally important.

IASB Chairman, Hoogervorst (2012) mentions that the difference between the net result and the comprehensive result through the notions "other comprehensive income items" is not yet clearly defined. The calculation of the comprehensive income in compliance with the requirements of IAS 1 "Presentation of financial statements" reviewed is difficult, exposing the financial statements to possible manipulation. The concept of comprehensive income does not eliminate the concept of net result taking g into account that "other comprehensive income items" are reclassified (recycled) in the profit and loss account profit as they are realized at a later date.

Felthman and Ohlson (1995) argue that these two income concepts cannot be ranked.

4. Conclusion

The problem of the conceptualization and especially of the measurement of the company performance under the impact of the international accounting standards is far from receiving a satisfactory reply given the asymmetric information, the many and different objectives of the business entities. The concept of income agreed by the users of the financial statements on long-term is the one that measures the value changes between the two balance sheets, and it takes into account the expenses and the incomes generated by the current operations as well as the profit or loss from holding assets.

The comprehensive income maintains both the usefulness of the balance sheet as well as that of the profit and loss account. The net income is maintained in the structure of the comprehensive income, as the most adequate indicator of the current operating performance.

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