
The Financial Accounting Standards Committee of the American Accounting Association (hereinafter, the Committee) is charged with responding to requests for input from standard setters on issues related to financial reporting. The Committee is pleased to respond to the invitation to comment on the Special Report of the G4+1 (hereinafter, the “Group”), “Reporting Financial Performance: A Proposed Approach” (hereinafter, the “special report”). The comments in this letter are based in part on the Committee’s review of academic research. The opinions reflect the views of the individuals on the committee and not those of the American Accounting Association.

GENERAL COMMENTS

The committee supports the G4+1’s systematic reconsideration of the number and format of financial statements. This reconsideration is necessary and appropriate because the piecemeal approach to accounting standard setting within most countries has resulted in performance reporting that lacks a coherent framework. Moreover, through this review the G4+1 can and should address inconsistencies in performance reporting across jurisdictions, especially with respect to the definition of performance.

The committee thanks D. Shores for her work on a related project, much of which is incorporated in this document.
RESPONSES TO QUESTIONS AND
COMMENTS ON PROPOSED APPROACH

Where practicable, our comments and responses are based on evidence from existing research. Descriptions of most of the papers we cite appear in the Appendix.

Q1: Do you agree with the Group’s conclusion in Chapter 2 that financial performance should be presented in one statement rather than two or more statements?

Yes. We see no conceptual or practical benefits to multiple statements and we believe there may be some costs to users of a multiple-statement approach. Research on the effects of presentation and format is sparse and primarily behavioral-experimental. Some evidence, however, suggests that reporting format is important. Of particular relevance to this issue are two experimental investigations of whether the reporting format for comprehensive income affects decisions by analysts (Hirst and Hopkins 1998) and nonprofessional investors (Maines and McDaniel 2000). Hirst and Hopkins (1998) conclude that a single-statement approach (as opposed to reporting comprehensive income in the statement of shareholders’ equity) enhances analysts’ identification of earnings management and reduces the bias in their valuation judgments. Maines and McDaniel (2000) conclude that a single-statement approach increases the likelihood that nonprofessional investors use comprehensive income information to assess corporate performance. They suggest that nonprofessionals view the choice to present the information in income as a signal of its nature and importance.

Q2: Do you agree with the proposed structure of a single statement of financial performance divided into the following three components:

(a) the results of operating (or trading) activities
(b) the results of financing and other treasury activities; and
(c) other gains and losses?

If you do not agree, can you suggest a division that would be more useful? Please give reasons for preferring your alternative.

The Committee has comments on three aspects of the current proposal: (1) the clarity of the Group’s goals, (2) the definition of an implementable classification mechanism, and (3) the specific proposal to segregate operating, financing, and other items. In addition, the Committee proposes an additional disclosure to accompany the report.

Comments on the Clarity of the Group’s Goals

The Committee believes that any proposal for a statement of financial performance should contain a clear articulation of its conceptual goals, and explicit and fully developed links among the conceptual goal(s), the proposed structure of a performance reporting statement, and the observable characteristics of earnings components that determine classification within this structure. Given that implementing any proposed approach will require significant judgment, and given that new activities will arise that may require accounting recognition in a performance report, the Group’s objectives should be very precise in order to increase the consistency and comparability of standards and to reduce the incidence of abuse or simple misunderstanding.

The Group states that its proposals about reporting financial performance derive from a predictive ability or predictive value objective (para. 1.5 and para. 1.6) and takes
as given that all gains and losses are useful for this purpose (para. 1.10). The Group recognizes there is cross-sectional variation in the degree to which earnings components have direct predictive ability and that some performance-related items are "relevant" not because they directly have predictive ability, but because they aid in assessing or evaluating the predictive ability of other items (para. 1.8). The proposed structure that segregates operating items, financing items, and other gains and losses, reflects an apparent assumption that "predictive ability" is related to the nature of the activity that generates the earnings.¹

Comments on the Definition of an Implementable Classification Mechanism

Linking the "predictive ability" objective to an implementable performance-reporting structure will require more specificity about both the construct to be predicted and the activity that will benefit from improved predictive ability. In terms of the construct to be predicted, the special report provides a broad, tripartite construct: the "amount, probability, and timing of future cash flows" (para. 1.6).² No single performance reporting structure will dominate all others for improving this broad concept of predictive ability.

The special report does not specifically identify the activity that will benefit from improved predictive ability of one or more of the three noted features of cash flows. We assume the Group intends for improved predictive ability to benefit valuations (including equity valuations) for which future earnings, future dividends, and/or future cash flows may be relevant. One issue that should be addressed in adding specificity to the predictive ability criterion is the "future" period over which earnings and/or cash flows and/or dividends are to be predicted for valuation purposes. Over infinite horizons, it makes no difference whether valuations are based on earnings, cash flows, or dividends—all three are equivalent. Over finite horizons in general and over the short horizons adopted for most practical valuation activities, the nature and difficulty of the prediction task differ depending on whether earnings, dividends, or cash flows are being valued. Research indicates that valuations based on predicted earnings tend to require shorter forecast horizons to yield better measures of intrinsic value (where intrinsic value is measured as stock price); see, for example, Francis et al. (2000) and Penman and Sougiannis (1998). Valuations based on P/E multiples reduce the forecasting horizon to one year. Research indicates that P/E multiples are more accurate in terms of better pricing or lower analyst forecast errors when earnings growth and other firm characteristics likely associated with earnings persistence are considered (e.g., Kim and Ritter 1999; Boatsman and Baskin 1981; Alford 1992).

The performance-reporting structure proposed in the special report suggests that the concept of predictive ability the Group has in mind is related to (1) the sustainability of earnings (in a mean or average sense), and (2) uncertainty about sustainability, and that these items are associated with the nature of the activity that generates the earnings. Existing theoretical and empirical academic accounting research supports the first point that predictive ability is associated with earnings persistence. Valuations based

¹ Para. 2.20 suggests that standard setters should specify the distinctions among the three proposed categories of the proposed statement of financial performance. Comparability among the standards will be enhanced if the objectives for making these distinctions are explicit.

² This predictive purpose of financial statements is consistent with the underlying principles of financial reporting espoused in FASB Statement of Concepts No. 1.
on earnings are improved, in terms of a higher statistical association between earnings and equity values, when earnings of different persistence are valued using different multiples. These studies document cross-sectional differences in earnings multipliers that are related to the earnings' persistence, measured using time-series models (Kormendi and Lipe 1987; O'Hanlon et al. 1992; Ramesh and Thiagarajan 1993) or based on intuition (Fairfield et al. 1996; Lipe 1986; Wild 1992). (Note that we base our response to Q2 on the body of academic accounting research that examines the relation between equity values or returns and earnings, in total and its components. The limitations of this research and detailed descriptions of most of the cited papers are discussed in the Appendix.)

Hence, an obvious theoretical construct for disaggregating earnings components is their persistence or sustainability. However, we believe it is difficult or impossible to define an implementable classification scheme based on the concept of persistence, for several reasons. First, research that shows a link between equity values and persistence defines persistence based on outcomes from activities, not based on the nature (i.e., the frequency or regularity) of the underlying activity itself. For example, sales arise from a highly persistent activity but the reported sales revenue numbers may exhibit significant transitory (impersistent) elements. A repeated activity may or may not produce outcomes that are useful for prediction. Second, several studies suggest that the assessed "persistence" of earnings components varies as a function of firm-specific characteristics such as financial health, firm size, or industry (Barth et al. 1996; Wild 1992), or as a function of whether the item is a gain or loss (Hayn 1995). Third, persistence can depend on the accounting treatment of the earnings component. Finally, while persistence is a continuous concept, some potentially useful characterizations are dichotomous (e.g., recurring vs. nonrecurring), and the literature sometimes uses similar terms (e.g., sustainable, recurring, persistent, core) without making clear whether these terms are intended to refer to the same construct or distinct constructs.

Turning now to the second point—the relation between predictive ability and uncertainty about the sustainability or persistence of earnings—existing empirical research provides no direct evidence. We agree with the Group's claim that time-series volatility should not be taken as an indication that earnings do not have predictive ability (para. 1.9). To the extent volatility in an earnings component reflects underlying economic volatility, the earnings-component volatility may be useful for monitoring purposes or indirectly useful for prediction purposes.

However, the claim in para. 1.9 does not imply that all time-series volatility increases predictive ability; "artificial" volatility (i.e., it does not reflect underlying economic volatility) may provide no benefit, and it is well known that earnings volatility can create costs related to the use of accounting information in contracting, including regulation. For example, Cornett et al. (1996) show a negative market reaction to the fair value accounting standards for banks that is more negative for banks near their capital requirements. The results suggest that accounting requirements that increase earnings volatility and thus increase the likelihood of violating bank capital requirements.

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Footnote 3: For example, management's choice of depreciation policy and assumptions about depreciable lives affect the persistence of "other" gains or losses at disposal, and the decision to measure securities at their fair values vs. their historical costs has implications for the persistence of income elements derived from these investments.
create real economic costs, unless regulators adjust for the accounting treatments. Research does not speak to the question of whether standard setters should take into account existing regulations (e.g., bank capital regulations) and existing contracts (e.g., lending agreements) and the resulting costs in assessing a proposed standard.

The special report does not link the proposed activity-based disaggregation scheme to predictive ability by suggesting that these activities either differ in persistence or provide information about uncertainty of persistence, which are the conceptually correct disaggregation constructs. We are aware of no research which studies the valuation implications of income elements disaggregated based on the nature of the activity that generated them, and no research which attempts to develop explicit links between persistence or the uncertainty of persistence and the nature of the activity that generated an income element. Earnings from different activities have different multipliers in equity valuation empirically *not* because of the nature of the activity generating the earnings, but because the nature of the activity is a proxy for persistence.

**Comments on the Specific Proposal to Segregate Operating, Financing, and Other Items**

Available research results provide no evidence that financing and operating activities should be segregated *per se* for equity valuation purposes, as is proposed in the special report. It is possible that this separation is consistent with a properly specified predictive objective, but that question is not addressed in the special report. In addition, the goal of improved predictive ability is pertinent to claimants other than equity holders. The equity-valuation research we examine sheds no light on the implications of separating operating and financing-related items for creditors and other similarly-situated users of financial reports. Such a separation is, however, consistent with the format of the statement of cash flows.

The category of other gains and losses proposed in the special report should be considered in light of research evidence that some "other" components of earnings have no direct predictive ability. As indicated in para. 2.12 and related discussion, the category "other gains and losses" would include gains and losses related to external price changes (e.g., fair value changes in securities; foreign currency gains and losses). Warfield and Linsmeier (1992) suggest that earnings related to price changes of assets priced in efficient markets are unpredictable. If realized gains and losses that have no predictive ability (Warfield and Linsmeier 1992) or earnings that are statistically unrelated to share values (Ramakrishnan and Thomas 1998) are aggregated with operating earnings that are sufficiently persistent as to possess predictive ability, and the extent of aggregation is not known, then the operating earnings amount will have less predictive ability. Such components, however, can have indirect predictive value. For example, transitory losses may indicate that capital needs will be higher in the future and increase.

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4 In contrast to the evidence that volatility has real economic costs for banks, Barth et al. (1995, 580) find bank share prices did not reflect the volatility of fair-value-based earnings or the capital violations that would have occurred if fair value accounting were in place. However, share prices of banks reflected the volatility in earnings measured using historical cost accounting and historical cost accounting violations. The authors claim that these results should be interpreted with caution. This study—conducted during a period in which the accounting regime was historical cost accounting—may simply imply that, in such a regime, fair value "volatility" and fair value violations were not costly.

5 Such a separation, however, will be useful for certain valuation model applications (i.e., valuing payoffs to equity claimants vs. debt claimants).
the expected cost of obtaining capital. One solution to the problem of reporting gains or losses that have no direct predictive ability is to continue, and most likely expand, the current practice of direct debits and credits to shareholders' equity. This solution would however conflict with the Group's proposal (with which we concur) to develop a single, comprehensive report of financial performance. Another solution, consistent with the single-statement approach, is to maintain a comprehensive income approach but require disaggregation of items with no direct predictive ability (i.e., no persistence).

**SUGGESTION TO CONSIDER ADDITIONAL DISCLOSURES**

Given that the association between activity-based earnings components and persistence is firm-specific, the Group might consider requiring disclosures about a firm's business and business model that will improve the predictive ability of a performance report. While a time-series of historical earnings can be used to assess the *ex post* persistence of earnings generated from a given set of underlying activities, future persistence will depend on management's decisions that can change the underlying activities that generate earnings components. Currently, disclosures about a firm's activities and business plans are included in Part 1 of the 10-K for U.S. registrants and in Management's Discussion and Analysis.

Q3: Do you agree with the matrix, shown in para. 2.12, that would be used as the basis for allocating items of recognised [sic] financial performance between operations and other gains and losses?

No. As noted in our response to Q2, we believe a classification matrix like the one in para. 2.12 should be explicitly linked to the ultimate goal of predictive ability. Assuming that differences in predictive ability are linked to components that either differ in persistence or provide information about the uncertainty of persistence, the special report should be clear that the characteristics suggested to distinguish operating items from other items are only representative characteristics that financial statement preparers should consider when assessing the item's persistence, (i.e., as in the criteria for assessing the realizability of deferred tax assets in SFAS No. 109).

Given that the special report has not developed clear links between the Group's objective and this classification scheme, the matrix in paragraph 2.12 can cause confusion. One interpretation of the fourth set of characteristics that differentiates operating from other items is that operating items are more under the control of management (internal events) while other items are outside management control (external events). With respect to valuation, there is no empirical or theoretical justification for such a breakdown between items under managerial control and those not under managerial control. However, there is justification for such a breakdown if earnings resulting from internal events are more persistent than earnings resulting from external events (consistent with the results of Soo and Soo [1994], for example). If the Group intends that earnings resulting from external events should be segregated because they are more likely to exhibit lower persistence, this intention should be made clear.

Para. 2.12 of the special report suggests that four characteristics are useful in distinguishing operating items from other items. Operating items are more likely to be (1) generated by operating activities, (2) recurring, (3) related to nonholding items, and (4) related to internal events such as "value-adding activities." Distinguishing "operating" from "other" items on the basis of these four characteristics is not implementable because characteristics can overlap in a given item. Suppose management decides to restructure
some aspect of a firm's current operating activities (an internal decision) in response to external events. Applying the matrix in para. 2.12, this restructuring is likely a nonrecurring, operating activity that involves both holding and nonholding items and both internal and external events. There is no clear classification of this charge.

Q4: Chapter 3 looks at how the matrix would be used to allocate items to components. Do you agree with the way the matrix has been applied to:

(a) foreign currency translation adjustments; and
(b) changes in the value of fixed assets

As noted earlier, we believe the matrix approach developed in the special report is not implementable. We believe the characteristics used to allocate items to components should be linked explicitly to predictive ability based on persistence.

Q5: Chapter 4 discusses whether recycling between the different components of the statement should be permitted. Do you agree with the conclusion that recycling should not generally be permitted?

Yes. Although empirical research does not directly address the issue of recycling, our interpretation of existing research on the pricing of particular income statement components suggests that recycling would not improve predictive ability, as this construct is operationalized in the existing research.

Q6: Chapter 5 discusses unusual, abnormal, and exceptional items.

(a) Do you agree with discarding the concept of extraordinary items?
(b) Do you agree that abnormal/exceptional items should not be reported as a separate category of revenues and expense?

As noted earlier, we believe that all income items should be grouped to place items with similar persistence together and to separate items with dissimilar persistence. These criteria should also apply to abnormal/exceptional items.

(c) Do you think that entities should be required to disclose trends over time in a historical summary to highlight any pattern of reporting abnormal/exceptional items?

Yes, we support an historical summary although not necessarily because it will highlight abnormal exceptional items. Assuming full-market efficiency (which in effect disregards information-processing costs) and full disclosure of abnormal/exceptional items at the time of their recognition, reporting vs. not reporting a historical trend should be irrelevant for equity valuation. Disclosure of historical trends in earnings components defined on a consistent basis would simply reduce users costs of making over-time comparisons. Evidence suggests that financial statement users are affected by presentation format, either because of information processing costs or irrationality. Behavioral research such as Hirst and Hopkins (1998) and Maines and McDaniel (2000) and empirical-archival research such as Abarbanell and Bushee (1997) indicate that the identification and use of financial statement information is sensitive to how information is presented.

In addition, if preparers can shift the ways in which earnings components are aggregated from year to year, disclosure of historical trends on a restated basis potentially
provides two types of information. First, the prior-period amounts that are restated to be consistent with the current-period presentation represent information that was not available in prior-period reports. Second, depending on the classification structure the Group proposes for aggregating earnings components, changes in aggregation are potentially informative about the firm's future operating/financing plans relative to its historical model.

Q7: Chapter 6 examines how discontinuing and continuing information could be disclosed within the statement of financial performance.

(a) Do you agree that information of this nature is useful?
Yes, because discontinuing an activity affects persistence, by definition.

(b) Do you think that discontinued activities should be classified as such only when the decision to discontinue is irrevocable?
The committee is not aware of any research that addresses this issue.

(c) Would you prefer to see such information on the face of the statement or is disclosure by note sufficient?
Please refer to the response to Q6(c).

Questions 8 through 10 are addressed jointly.

Q8: Chapter 7 covers the allocation of tax expense to the components of the statement of financial performance. Do you agree with the proposal that tax expense should be allocated only to (i) the total of operating and financing activities and (ii) other gains and losses (with additional disclosure of the tax related to individual items in "other gains and losses")? If not, please indicate which of the alternatives referred to in the chapter you support and why.

Q9: Chapter 9 looks at the accounting treatment of voluntary changes in accounting policy. Do you agree with the proposed treatment of such changes as prior period adjustments, i.e., retrospective application with restatement of prior periods?

Q10: Chapter 9 examines the treatment of changes in estimate and the correction of errors.

(a) Do you agree that changes in estimates should be reported in the period in which the change is made?

(b) Do you agree that material errors should be treated as prior period adjustments, i.e., retrospective application with restatement of prior periods?

Yes, conditional on the development of a well-specified predictive ability criterion, and its use to define the components of a performance report. While we do not know the precise form such a criterion will ultimately take, related to all points in Questions 8–10, the proposed accounting treatments of taxes, accounting policy changes, estimate changes, and errors would very likely be consistent with a well-specified predictive ability criterion, which we support.
APPENDIX
SUMMARY OF RESEARCH USED AS A BASIS FOR RESPONSES

Nature and Limitations of the Research

The research we use as a basis for some of our responses is subject to several limitations. First, the evidence based on empirical-archival research is limited to tests of what is currently reported and cannot anticipate the effects of what might be reported. For example, tests of valuation relevance of earnings components are based on earnings as they are currently disaggregated. Second, the studies often design empirical tests to increase the likelihood of detecting a relation that is hypothesized to exist in the data. For example, studies examining securities gains and losses have typically focused on financial institutions because securities gains and losses are likely to be material for these firms. This design choice potentially limits the generalizability of the results to other types of firms.

Third, these studies are designed to test only for the benefits of disaggregation of performance-related items. They ignore the potential reporting costs of disaggregation, including bookkeeping costs, or increasing competitive disadvantage. Finally, these studies typically rely on the assumption that equity markets (or analysts) are informationally efficient. This assumption is needed to support inferences about persistence of earnings components based on associations between earnings components and equity prices.

We review selected research papers that differ in the earnings components considered and the method for determining the persistence of those components. Some studies use time-series models to determine persistence. Other studies base tests for differences in persistence across income components on intuition, or link cross-sectional variation in persistence to some firm characteristic. Our review starts with studies that consider broad classifications of earnings based on persistence and proceeds to studies that consider only one particular earnings component.

The studies also differ on two other dimensions. First, some studies examine the explanatory power of models that include disaggregated earnings components (based on the adjusted $R^2$ of the model), while others focus on the significance of the statistical association between a particular earnings component and a market-based measure such as stock price. Second, some studies examine the association between earnings and stock prices, while others focus on unexpected earnings and stock price returns.

Transitory vs. Permanent Earnings

Several papers show that transitory earnings surprises are valued at a lower multiple than permanent earnings surprises, without defining transitory and permanent earnings based on reported income statement classifications. For example, Freeman and Tse (1992) provide evidence that the marginal stock price response to an earnings surprise declines as the magnitude of the surprise increases. This analysis represents a joint test of the hypothesis that larger surprises are more likely to be transitory and that the market applies a lower multiplier to these surprises. O'Hanlon et al. (1992) similarly show cross-sectional variation in the relation between stock returns and earnings surprises for a sample of U.K. firms related to persistence, using a time-series model to disaggregate persistent and nonpersistent earnings. Ramesh and Thiagarajan (1993) also use a statistical method to decompose income from continuing operations into its permanent and transitory components. Consistent with the results of O'Hanlon et al. (1992) that the magnitudes of investor responses to earnings components vary with persistence, they provide evidence that a larger proportion of security returns is explained when income from continuing operations is decomposed into its persistent and nonpersistent components than when it is not decomposed.

Components of Earnings

Several papers provide evidence that variation in persistence across income statement classifications explains cross-sectional variation in equity-based valuation metrics. The papers
examine different decompositions of earnings into components. Lipe (1986) disaggregates income from continuing operations into six components (i.e., gross profit, general and administrative expenses, depreciation, interest expense, income taxes, and other items). The choice of these components is based on data availability, and the hypothesis that the earnings multipliers differ is based on an *ad hoc* assumption that these components have different persistence. Each component helps explain security returns, and the multiplier placed on each component is related to its historical persistence.

Ramesh and Thiagarajan (1993), cited previously, show that conventional income statement components including gross margin, operating expenses, depreciation, interest expense, and special items are associated with both the permanent and transitory earnings metrics derived from their statistical decomposition of income from continuing operations. Wild (1992) examines the association between firm value and six earnings components (revenues, operating expense, depreciation, interest expense, taxes, and other) and five book-value components (working capital, capital expenditures, long-term assets, long-term debt, and preferred stock) for 515 randomly selected firm-year observations during 1983–1985. As expected, each selected item conveys value-relevant information; the relative informativeness of each item differs across industries and company size.

Fairfield et al. (1996) focus on predicting one-year-ahead return on equity (ROE) based on successively finer disaggregations of net income as follows: (1) net income; (2) income from continuing operations and nonrecurring items; (3) income from continuing operations excluding special items, special items, and nonrecurring items; (4) operating income, nonoperating income, taxes, special items, and nonrecurring items; (5) gross margin, selling and administrative expenses, depreciation, interest expense, minority income, nonoperating income, taxes, special items, discontinued operations, and extraordinary items. The accuracy of predictions increases monotonically across the first four models (disaggregation at the level of the fifth model results in a slight deterioration in accuracy relative to the fourth model). Thus, components of net income conventionally reported increase its predictability with the exception of further disaggregating operating income and nonrecurring items.

Bublitz and Ettredge (1989) disaggregate advertising expense and research and development expense from income from continuing operations because these components are expensed as incurred rather than capitalized and amortized over their estimated useful lives. The multipliers placed by the capital market on both advertising expense and research-and-development expense differ from the multiplier on other expenses included in income from continuing operations, consistent with measurement affecting the implications of financial performance items for equity valuation.

**Comprehensive Income**

Analyses of total comprehensive income and its components are confounded by reporting format issues because current standards permit the reporting of comprehensive income in either one or two statements. Using experimental methods, Hirst and Hopkins (1998) test whether the format for reporting comprehensive income influences financial analysts' decisions. The authors conclude that reporting other comprehensive income in a statement of financial performance enhances analysts' acquisition of information related to comprehensive income, improves identification of earnings management, and reduces the bias in their valuation judgments relative to reporting other comprehensive income in the statement of changes in stockholders' equity. Maines and McDaniel (2000) analyze the effects of reporting of comprehensive income on *nonprofessional* investors also using experimental methods. In contrast to the results of Hirst and Hopkins (1998), the results show that nonprofessionals acquire comprehensive income information regardless of its presentation format. This result is consistent with differences in the information-acquisition processes of professionals and nonprofessionals—professionals (i.e., analysts) are more likely to use a directed-search strategy to acquire specific information, while nonprofessionals are more likely to read the entire set of financial statements. However, once nonprofessional
investors in the experiment acquired the comprehensive income information, they were more likely to use it to evaluate performance when it was presented as a component of the income statement. Both studies suggest that reporting format affects the use of financial reports, which casts some doubt on the maintained assumption of market efficiency made in most empirical-archival research on comprehensive income.

Two papers attempt to compare the value relevance of comprehensive income to other earnings components, but the results of both papers have been challenged. Using cross-sectional tests, Cheng et al. (1993) conclude that income from continuing operations explains more of the variation in equity returns than does net income, but net income has higher explanatory power for returns than comprehensive income. In addition, the nonoperating component of net income and the other comprehensive income component of comprehensive income have different valuation multipliers. The authors do not attempt to identify reasons for this differential pricing. Dhaliwal et al. (1999) provide evidence that although other comprehensive income in general helps to explain security returns, this result appears to be driven by the adjustment for securities gains and losses for firms in the financial sector.

Soo and Soo (1994) provide evidence that the valuation multiplier on other comprehensive income is smaller than the multiplier on income from continuing operations. However, Bartov (1997) finds that this result holds only for firms that designate a foreign currency as their functional currency (otherwise, the other comprehensive income component is not helpful in explaining security returns). In addition, the two studies find different results for the component of foreign exchange gains and losses included in income from continuing operations. Soo and Soo (1994) find this component is priced similarly to the remainder of income from continuing operations. Bartov (1997) finds that this component is not helpful in explaining security returns. Although these results are inconclusive, both studies provide evidence that supports separately reporting the other comprehensive income component of foreign exchange gains and losses.

Further evidence on the nature of the relation between the components of other comprehensive income and security returns is provided by research conducted before comprehensive income disclosures were required. In SFAS No. 130, the FASB has defined other comprehensive income to include the change in the balance of unrealized gains and losses on marketable securities available-for-sale; the change in the cumulative foreign currency translation adjustment; the change in the net of tax additional minimum pension liability in excess of unrecognized prior service costs; and the change in the market value of a hedge of a SFAS No. 115 security. Some of these items have been the subject of academic research, in part because they were disclosed separately prior to SFAS No. 130.

Unrealized Gains and Losses on Securities

For a sample of banks Ahmed and Takeda (1995) find that the change in unrealized securities gains and losses has explanatory power for security returns. Petroni and Wahlen (1995) find similar results for a sample of property-liability insurers. However, further analysis indicates that the results hold for equity investments and U.S. Treasury investments, but not for other types of investment securities such as municipal and corporate bonds. The authors suggest that reported unrealized gains and losses for these latter securities are not value-relevant because the securities are less actively traded and, hence, the measurement of unrealized gains and losses is less reliable.

Barth et al. (1996) test the relation between balance-sheet “levels” of fair values for financial instruments and market values of equity and the relation between first differences in the market values of financial instruments and returns. The results indicate that changes in fair values (unrealized gains and losses on loans) have explanatory power, and the explanatory power is

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6 This result is in contrast to the results reported in Barth (1994). However, Ahmed and Takeda's (1995) evidence suggests that Barth's (1994) results are likely to be confounded by not including a variable to capture the changes in the values of other assets/liabilities from interest rate changes.
higher for healthy banks (greater persistence). However, this study covers a period before the disclosures were required, and other research finds weaker results for the levels analysis (Eccher et al. 1996) or sensitivity of results to additional control variables such as ROE and growth in book value (Nelson 1996). Finally, Barth et al. (1996) analyze banks for which unrealized gains and losses on financial instruments are likely different from the unrealized gains and losses on the more passive investment portfolios held by nonfinancial firms.

Related to unrealized gains and losses on securities, an event study by Cornett et al. (1996) shows negative (positive) abnormal stock price reactions for sample banks to announcements that signal an increased (decreased) probability of issuance of fair value accounting standards that would apply to bank assets but not liabilities. The magnitude of the reaction is negatively related to a bank’s primary capital ratio, which suggests that increasing earnings volatility in the presence of regulatory earnings-based capital requirements imposes real costs on a firm. Beatty et al. (1996) find similar results for a sample of banks, but no negative share-price responses for their sample of insurance companies. However, the two studies do not consider the same events, and the dates on which bank share values reacted most strongly are not identical across the two studies.

**Foreign Currency Translation Gains/Losses**

As previously discussed, Soo and Soo (1994) and Bartov (1997) provide traditional value-relevance studies of foreign currency gains and losses. Two other papers provide conflicting results about whether reporting foreign currency translation gains and losses as an equity adjustment improves earnings predictability. Chen et al. (1990) show a significant decrease in the dispersion of analysts’ earnings forecasts following the adoption of SFAS No. 52 by a sample of affected multinationals. Forecast dispersion, which captures disagreement analysts’ earnings forecasts, is viewed as an inverse measure of earnings predictability. However, Sheikholeslami (1992) does not find that the switch from SFAS No. 8 to SFAS No. 52 improved earnings forecasting. He concludes instead that SFAS No. 52 “has become an instrument of earnings management by multinational companies.”

**Minimum Pension Liability**

Barth et al. (1993) disaggregate various pension expense components from the remainder of income from continuing operations. In regressions of security returns on the expense components, they find differences in coefficients (multipliers) consistent with predicted differences in persistence. In addition, the multipliers on the pension components (except for transition asset amortization that is predicted to be transitory) are larger than the multipliers on the nonpension components as expected based on differences in persistence and risk. They make the point, however, that the information conveyed by the disaggregation of income elements can also be discerned from the pension balance sheet data.

**Below-the-Line Items**

Collins et al. (1997) provide evidence that the proportion of security returns explained and the multiplier the capital market places on net income are both smaller for firms reporting discontinued operations, extraordinary items, and/or special (APB No. 30) items. Dharan and Lev (1993) disaggregate the component of income from continuing operations related to all accounting principle and estimate changes. While the remaining component of income from continuing operations has explanatory power for security returns, the accounting change component does not. This result holds for all firms together as well as for subsets of the firms based on whether they made net income-increasing or net income-decreasing accounting changes in the period.

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7 The majority of the changes relate to inventory, depreciation, investment tax credit, pension, and oil and gas accounting.
For a sample of property-casualty insurers, Anthony and Petroni (1997) segregate the income component related to the corrections of prior claim expense estimates (this component is a required disclosure for their sample firms). The multiplier the capital market places on the corrections component is both smaller than the multiplier on the remainder of income from continuing operations and negatively related to the standard deviation of the corrections reported in prior years. This result suggests that the market places less weight on components that are less reliably measured assuming that the historical standard deviation is a reasonable measure of accuracy.

Special Items/Other

One study of restructuring charges reports that these charges enhance the relation between book values and market values (Jennings et al. 1998)—this evidence provides indirect support for the view that separating restructuring charges from other earnings components provides useful information.

A number of studies have disaggregated realized gains and losses on marketable securities from income from continuing operations. The majority of these studies focus on banks where securities gains and losses are likely to be material. For example, Warfield and Linsmeier (1992) find that the multiplier the capital market places on realized securities gains and losses is smaller than the multiplier on the remainder of income from continuing operations. If the market for these securities is efficient, this period’s realized gains and losses have no predictability for future securities gains and losses. In addition, the authors provide evidence that the multiplier on the realized gains and losses component is insignificant in the fourth quarter and interpret this as consistent with tax-planning incentives for sales likely being greatest in that period.

Financial Reporting Discretion and Earnings Management

Incentives to manipulate earnings across components arise from the existence of different valuation multipliers for different components. For example, managers wishing to increase share values have an incentive to manipulate income increases into components viewed as persistent and income decreases into components viewed as transitory. Many academic studies have examined the incentives for and existence of earnings management; we discuss two studies that relate directly to financial statement classification issues.

Godwin et al. (1998) report results that suggest income statement motivations influence managers of property-liability insurers in their classification choices for securities on the balance sheet. Hoffman and Zimmer (1994) exploit a natural experiment provided by a change in Australian reporting rules. The Australian standard on income statements (AAS No. 1) was recently amended to require that extraordinary items be nonrecurring. The amendment applied to 1990 financial statements, but the Corporations Law required that comparative financial statements for 1989 that complied with the new rule be included with the 1990 financial statements. Comparison of the amended financial statements with actual financial statements for 1989 indicates that managers whose compensation is large relative to earnings are more likely to classify gains as operating and losses as extraordinary.
REFERENCES


