Does the Reporting Location Moderate the Impact of Comprehensive Income Volatility on Equity Valuation?

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Abstract

This research examined the moderating impact of comprehensive income reporting location on the relationship between comprehensive income volatility and equity valuation, using a sample of 74 non-financial publicly traded firms, listed on the Egyptian Stock Exchange, over the period from 2014 to 2019. Two years (i.e. 2014 & 2015) before the implementation of adjustments to the Egyptian Accounting Standard No. (1) issued in 2015, and four years after the implementation (i.e. 2016-2019). The findings revealed that investors in the Egyptian stock market are affected by the "reporting location" of comprehensive income. Investors incorporate comprehensive income volatility and the incremental volatility of comprehensive income over net income into equity valuation only when comprehensive income is reported saliently in a separate statement. The findings conform with the "bounded rationality", and "the limited attention hypothesis". In addition,

applying international financial reporting standards (IFRS) enhances the efficiency of the Egyptian capital market.

Keywords: Comprehensive Income Volatility, Net Income Volatility, Stock Prices, Reporting Location, Equity Valuation.

الملخص

هدف البحث الي تحديد أثر موقع التقريرعن الدخل الشامل في القوائم المالية على تقييم حقوق الملكية، تكونت عينة الدراسة من ٧٤ شركه من الشركات غير المالية المقيدة ببورصة الأوراق المالية المصرية عن الفترة من ٢٠١٤ الي ٢٠١٩. أوضحت نتائج الدراسة وجود تأثير معنوي ذو دلالة إحصائية لموقع التقرير عن الدخل الشامل على تقييم حقوق الملكية، حيث ان المستثمر يستطيع الاستفادة من تقلب قيم الدخل الشامل فيما يتعلق بتقييم المخاطر وانعكاس ذلك على أسعار الأسهم فقط عندما يتم التقرير عنة في قائمة الدخل الشامل، بينما لا يوجد هذا التأثير عندما يتم التقرير في قائمة التغيير في حقوق الملكية.

الكلمات المفتاحية: تقلب قيم الدخل الشامل، تقلب قيم صافي الدخل، أسعار الأسهم، موقع التقرير، طرق العرض، تقييم حقوق الملكية.

1. Introduction

Equity valuation is vital to the functioning of capital markets. It influences pricing decisions, investment portfolios, and risk management practices (Pinto et al., 2019). Equity valuation and risk are interrelated, a firm's market value is a function of the future expected payoff discounted for risk. Therefore another potential aspect of accounting is to provide information about discount rates (Jiang & Penman, 2013). Incorporating CI

information into equity valuation models is one of the ways to validate its usefulness (Dichev, 2017). For equity valuation purposes, investors need information about firms' expected cash flows and the uncertainty related to their realization. Income volatility reflects the uncertainty about a firm's future earnings, therefore it is essential for equity valuation (Ahmed & Hla, 2019). If investors utilized the reported earnings volatility to form their risk assessments, it would be a major covariate of equity risk. Hence, investors' assessments of the firm's stock risk based on accounting information, and its implications on equity valuation require further examination and dedicated research (Cordazzo & Rossi, 2020).

2. Literature Review and Hypothesis Development

2.1. Comprehensive Income Volatility Versus Net Income Volatility.

Barth (2004) specified three potential sources of earnings volatility; inherent volatility, measurement error volatility and the mixed measurement system. The inherent volatility arises from firms' activities and changes in macroeconomic factors. The measurement error volatility is related to the reliability of fair value estimates. The mixed measurement volatility results from the use of different measurement bases for similar assets and liabilities. U. Khan (2019) has illustrated that all measurement bases could induce volatility in earnings in different ways. Yen et al., (2007) conducted a content analysis of

financial institutions' comment letters on FASB's exposure draft on CI reporting. They illustrated that about 9% of the responses warned that the partial recognition of changes in fair values would induce artificial volatility in CI. Barth (2004) indicated that historical cost induces volatility in income. Under uncertainty, the historical cost defers the recognition of earnings to future periods (Jiang & Penman, 2013). Consequently, in some accounting periods, historical cost earnings could induce volatility in stock prices.

In contrast, Plantin et al. (2008) illustrated fair value measurements incorporate market-based risk factors into financial statements; therefore, they could cause more volatility in earnings than historical cost. Barth et al. (1995) indicated that the inclusion of unrealized gains/losses on investment securities caused U.S banks' earnings volatility to become 26 % higher than that of historical cost earnings. Similarly, Hodder et al. demonstrated that full-fair value earnings volatility is five (three) times higher than net income (comprehensive income) volatility. Consistent with their findings, Khan & Bradbury (2014),(2016); Abbass, D. A.,& Alrashedy (2020) and Cao & Dong (2020) illustrated that comprehensive income is subject to greater fluctuations than net income (NI). Hence, the first hypothesis is stated as follows:

H_1: "Comprehensive income experiences more volatility than net income "

2.2. The Relationship Between Reporting Location, Comprehensive Income Volatility and Equity Valuation.

According to the efficient market hypothesis, rational investors are expected to fully process publicly disclosed information regardless of where it is reported in financial statements (Schaberl & Victoravich, 2015). However, prior studies' findings (e.g., Chambers et al., 2007; Schaberl & Victoravich, 2015) are inconsistent with the efficient market hypothesis (EMH). In addition, practitioners and standard setters seem unconvinced that accounting information's reporting location does not affect its relevance. In June 2011, the Financial Accounting Standard Board (FASB) and the International Accounting Standard Board (IASB) issued Accounting Standards Update (ASU) No. 2011-05 to mandate the performance reporting of CI in a performance statement.

As a part of adhering to international accounting standards, in July 2015, the Egyptian Ministry of Investment and International Cooperation issued Act No. 110 for the year 2015, which enforced the performance reporting of OCI components under the amendments to Egyptian Accounting Standard No (1) *"presentation of financial statements*". Those amendments cope with the last updates of the international accounting standard (IAS 1) "*Presentation of Financial Statements"* revised in June

2011 except that the option of presenting one inclusive income statement is not permitted.

Opponents of performance reporting of OCI are concerned that the salient presentation of volatile, transitory, and incomplete information in a performance statement will increase users' assessment of the firm's risk and penalize stock prices. Yen et al. (2007) indicated that Approximately half of the comment letters submitted in response to the FASB's *Comprehensive Income Reporting Exposure Draft* expressed concerns that the volatility of CI would negatively affect investors' perception of a firm's riskiness. On the other hand, Barth (2004) pointed out that users of financial statements need to understand the various sources of financial statement volatility, hence, investors could precisely assess the riskiness associated with their investments. Concealing the volatility of the components susceptible to critical risk exposure does not serve users' needs. Instead, prioritizing accurate measurements and transparent disclosures empowers informed decision-making (Barth, 2004). Correspondingly, prior studies of Bloomfield, 2002; Campbell, 2015; Hirshleifer & Teoh, 2003 showed that investors fail to immediately price incomplete, and costly to extract information until future periods when they are demonstrated in future profits.

A stream of prior studies has examined the impact of the presentation formats of OCI on its value relevance and reached contradicting results. For instance, Maines & McDaniel (2000)

examined the differential effect of disclosure through financial statements' footnotes, statement of changes in stockholders' equity, and CI statements on nonprofessional investors' risk assessment of firms' financial performance. They found that investors weigh OCI volatility differently based on its reporting location. Investors are more likely to incorporate OCI volatility in evaluating firms' performance when OCI is reported in a performance statement. Similarly, Hirst & Hopkins (1998)'s findings showed that professional participants only impound unrealized gains or losses into their analyses when they are reported in a performance statement. Their findings are consistent with the "bounded rationality".

Moreover, Cao & Dong (2020) compared the risk relevance of OCI before and after the issuance of ASU 2011-05. Their findings displayed that investors are more likely to impound CI volatility into their risk assessment when such items are presented in a performance statement. In addition, Shi et al.(2017) found that the salient reporting of OCI components improved investors' interpretation of firms' financial performance, and enhanced the ability of NI to affect stock prices. Their findings are consistent with that of Wang et al. (2019) and Mita et al. (2020). In addition, Habiba (2017) examined the impact of changing the reporting location of OCI components on the cost of equity capital after the issuance of the amendments of EAS No. (1) in 2015. Their findings showed a significant reduction in the cost of equity capital when firms switched the reporting location of

OCI from the statement of changes in stockholders' equity to a separate CI statement.

On the contrary, Chambers et al. (2007) illustrated that OCI items are significantly priced by market participants when they are reported in equity statements. Similarly, Lin et al. (2018) found a reduction in the value relevance of OCI for firms that changed their presentation format from the equity statement to the performance statement after the implementation of ASU 2011-05. their findings are consistent with Schaberl & Victoravich (2015). However, Schaberl & Victoravich (2015) indicated that the reduction in value relevance of OCI could be temporary because investors are not familiar with the performance presentation format.

Conversely, Boulland et al. (2019), demonstrated that neither financial analysts nor non-professional investors timely process OCI information. Unsophisticated investors underprice OCI information, while financial analysts fail to incorporate it into earnings forecasts. They specified that a plausible reason would be investors' "*limited attention"*. The issuance of ASU 2011-05 did not increase investors' attention to OCI, a plausible explanation is that the currently implemented OCI reporting standard provides a less prominent presentation of OCI components compared to net income. Their findings are consistent with Mechelli & Cimini (2014). Provided the contradictory findings discussed above, the hypotheses could be formulated as follows:

H_{02}: the reporting location of comprehensive income does not significantly affect the relationship between comprehensive income volatility and equity valuation.".

H_{03}: the reporting location of comprehensive income does not significantly affect the relationship between incremental volatility of comprehensive income over net income volatility and equity valuation.".

3. The Research Method

3.1.Sample Selection

This research was conducted over a sample of 74 non-financial publicly traded companies, listed on the Egyptian Stock Exchange, over the period 2014-2019. Two years before the implementation of adjustments to the Egyptian Accounting Standard No. (1) issued in 2015, and four years after the implementation. The selection of the firms was based on a set of criteria. First, the researcher excluded banks and non-bank financial services because they are subject to unique risks because of the nature of their operations. Second, the company's trading currency is the Egyptian-bound. Third, the company's financial year ends on December 31st. Finally, the availability of the required data for variable measurements.

Data Sources

The data required for the study were obtained from various sources. Accounting data were hand-collected from the annual financial statements, extracted from; The "investor relations" section on the official website of the listed companies, Mubasher Info Egypt or The Egypt Company for Information Dissemination (EGID). Annual close prices were retrieved from the disclosure reports issued by the Egyptian Stock Exchange. The Yields on 90-day Egyptian treasury bills were extracted from the official website of the Central Bank of Egypt.

3.2.Variables Measurements

- **Measuring Comprehensive Income Volatility**

Following Cao & Dong, 2020; Hodder et al., 2006; and Khan & Bradbury, 2014, the researcher measured comprehensive income (CI) volatility, and net income (NI) volatility using a rolling standard deviation. First, each income measure was scaled by the average total assets. The calculation of comprehensive income volatility was based on financial data from 2012 to 2019. For the fiscal years 2016-2019, the researcher extracted "*as reported*" figures of (CI). For the years from 2012 to 2015, the researcher used *"as if estimates*" of OCI components and calculated the total CI based on gathered data from 2016's CI statement's comparative prior year data, statements of changes in

equity, or the footnotes to financial statements. Then, the rolling standard deviation was calculated over a three-year window ending in the years *t* 2014-2019, using "*Stata*" software. The incremental volatility of CI over NI was calculated by deducting CI volatility from NI volatility.

3.3.Model Specifications for Hypothesis Testing

- **Comprehensive Income Reporting Location and the Market Pricing of Its Volatility**

The purpose of conducting this analysis is to assess the impact of different reporting locations of CI (i.e., equity reporting versus performance reporting) on investors' pricing of comprehensive income volatility. The researcher adopted Hodder et al., 2006's simplified form of Ohlson, 1995's "*Residual Income Valuation Model (RIM*). Applying pooled ordinary-least squares (OLS) regression, the equations were estimated as follows;

$$P_{jt} = \alpha_0 + \alpha_1 BVE_{jt} + \alpha_2 ABNCI_{jt} + \varepsilon_{jt} \qquad (1)$$

$$P_{jt} = \alpha_0 + \alpha_1 BVE_{jt} + \alpha_2 ABNCI_{jt} + \alpha_3 (ABNCI_{jt} * DivPay_{jt}) + \alpha_4 DivPay_{jt} + \alpha_5 (ABNCI_{jt} * DE_{jt}) + \alpha_6 DE_{jt} + \alpha_7 (ABNCI_{jt} * OCF_{jt}) + \alpha_8 OCF_{jt} + \alpha_9 (ABNCI_{jt} * \sigma CI_{jt} * Location_{\boldsymbol{jt}}) + \alpha_{10} \sigma CI_{jt} + \alpha_{11} Location_{\boldsymbol{jt}} + \varepsilon_{jt} \quad (2)$$

$$P_{jt} = \alpha_0 + \alpha_1 BVE_{jt} + \alpha_2 ABNCI_{jt} + \alpha_3 (ABNCI_{jt} * DivPay_{jt}) + \alpha_4 DivPay_{jt} + \alpha_5 (ABNCI_{jt} * DE_{jt}) + \alpha_6 DE_{jt} + \alpha_7 (ABNCI_{jt} * OCF_{jt}) + \alpha_8 OCF_{jt} + \alpha_9 (ABNCI_{jt} * \sigma NI_{jt}) + \alpha_{10} \sigma NI_{jt} + \alpha_{11} \{ABNCI_{jt} * (\sigma CI_{jt} - \sigma NI_{jt}) * Location_{\boldsymbol{jt}}\} + \alpha_{12} (\sigma CI_{jt} - \sigma NI_{jt}) + \alpha_{13} Location_{\boldsymbol{jt}} + \varepsilon_{jt} \quad (3)$$

Where,

P_{jt} = the stock price of firm *j* at the end of year *t*.

BVE_{jt}= the book value of equity per share of firm *j* at the end of year *t*.

$ABNCI_{jt}$ = the abnormal comprehensive income per share of firm *j* at the end of year *t*.

$ABNCI_{jt} * DivPay_{jt}$ =An interacted regressor of *ABNCI* and *DivPay* of firm *j* at the end of year *t.*

$DivPay_{jt}$ = The dividend payout ratio of firm *j* at the end of year *t.*

$ABNCI_{jt} * DE_{jt}$ = An interacted regressor of *ABNCI* and *DE* of firm *j* at the end of year *t.*

DE_{jt} = The debt to equity ratio of firm *j* at the end of year *t.*

$ABNCI_{jt} * OCF_{jt}$ = An interacted regressor of *ABNCI* and *OCF* of firm *j* at the end of year *t*.

OCF_{jt} = The operating cash flow ratio of firm *j* at the end of year *t*.

$ABNCI_{jt} * \sigma CI_{jt} * Location$ = An interacted regressor of *ABNCI, σCI & Location* of firm *j* at the end of year *t.*

σCI_{jt} =Comprehensive income volatility of firm *j* at the end of year *t.*

$Location$ = A dummy variable that equals 1 for firms that report CI in the performance statement, and equals 0 for firms that report CI in the statement of changes in equity.

$ABNCI_{jt} * \sigma NI_{jt}$ = An interacted regressor of *ABNCI* and *σNI* of firm *j* at the end of year *t*.

σNI_{jt} = Net income volatility of firm *j* at the end of year *t*.

$\{ABNCI_{jt} * (\sigma CI_{jt} - \sigma NI_{jt}) * Location_{jt}\}$ = An interacted regressor of *ABNCI*, $(\sigma CI_{jt} - \sigma NI_{jt})$, and *Location* of firm *j* at the end of year *t*.

$(\sigma CI_{jt} - \sigma NI_{jt})$ = The excess volatility of *CI* over *NI* of firm *j* at the end of year *t*.

ε_{jt} = The error term.

The first equation is the base model of Ohlson, 1995, under which a firm's value in the market is a function of its book value and the present value of the expected future earnings. The book value of equity per share (BVE_{jt}) is a measure of the stock's intrinsic value. In theory, the coefficient estimate of BVE_{jt} (i.e. α_1) is expected to be positive and equal to 1. Following Cao & Dong, 2020, abnormal comprehensive income per share ($ABNCI_{jt}$) was used as a proxy for the future expected earnings. It was calculated by taking the difference of the comprehensive income per share at the end of year *t* (i.e. comprehensive income as a fraction of the number

of outstanding common shares) and the product of multiplying the risk-free rate of return at the beginning of year *t*, and the book value per share at the beginning of year *t*. The researcher proxied the risk-free rate of return using the yields on 90-day EGP T-bills at the beginning of the year *t*. The coefficient of the abnormal earnings "α_2" is expected to be positive.

Following Cao & Dong, 2020; Khan & Bradbury, 2014, 2016, the researcher controlled for financial solvency estimated by the debt-to-equity ratio (i.e. total Debt as a fraction of Total stockholders' Equity), liquidity measured by the operating cash flow ratio (Operating Cash Flow as a fraction of Current Liabilities) and, the firms' dividends policy measured by dividend payout ratio (i.e. Dividends per share as a fraction of earnings per share).

To test the research hypotheses, the interacting terms of abnormal comprehensive income with different accounting risk measures were added to reflect the moderating impact of these risk measures on the capitalization of future earnings. If investors price accounting risks in the capital market, the coefficient estimate of each of the two-way interaction effects of "*ABNCI*DE ", and " ABNCI* σNI"* is expected to be negative. Whereas, the coefficient for "*ABNCI*OCF"* estimates is expected to be positive. Firm size as a moderator regressor was excluded from the model specification to correct for high multicollinearity (Hair et al., 2018).

The following three-way interacting regressors were estimated;" *ABNCI*σCI*Location* "and *"ABNCI*(σCI-σ*NI*) *Location*" to investigate the moderating effect of CI volatility and the incremental volatility of CI over NI ($\sigma CI - \sigma NI$) on investors' discounting of the expected future earnings under each reporting location. $Location$ is a dummy variable that equals "1" for firms that report CI in a performance statement and equals zero for firms that report CI in a statement of changes in equity. If investors impound CI volatility and the incremental volatility ($\sigma CI - \sigma NI$) into stock prices, the coefficients of the three-way interaction terms are expected to be negative and significant.

3.4. Data Analysis and Empirical Results

- **Comparative Analysis of CI Volatility Versus NI Volatility**

Table (1):

Panel (A): The variance ratio test (F-Test)						
Variable	Obs	Mean	Std.Err.	Std.Dev	[95%Conf.	Interval]
σCI	440	0.047	0.002	0.044	0.043	0.051
σNI	440	0.035	0.001	0.029	0.032	0.037
2*Pr(F > f) = 0.0000						

Following Cao & Dong, 2020; Hodder et al., 2006; and Khan & Bradbury, 2014, *The variance ratio test* was used to assess the significance of the difference in the variances of the two income volatility measures. Table (1) panel (A) displays that non-financial

firms on average exhibit higher values and more dispersion of Comprehensive income volatility compared to net income volatility. The variance ratio test reveals that at p-value < 0.05 the null hypothesis of equal variance is rejected. Consequently, the variances of these two income measures are significantly different. In addition, the researcher conducted "*Levene's robust test statistic for equality of variance*" to boost the results of the variance ratio test. Both tests' results suggest that there is a significant difference between the volatility of CI and NI. Consequently, accept $\mathbf{H_1}$

3.5.Multivariate analysis

- **Reporting Location, Comprehensive Income Volatility, Equity Valuation**

Table (2);

Variables	Model (1) P	Model (2) P	Model (3) P
BVE	0.957*** (17.36)	0.966*** (16.31)	0.980*** (15.97)
ABNCI	1.403*** (3.573)	2.284*** (3.657)	2.279*** (3.176)
DivPay		3.758*** (2.834)	3.706*** (2.798)
ABNCI* DivPay		1.353 (1.647)	1.595* (1.933)
DE		2.610*** (4.693)	2.760*** (4.734)
ABNCI*DE		-0.395 (-0.923)	-0.110 (-0.250)

OCF		4.715***	4.689***
		(3.950)	(3.884)
ABNCI* OCF		1.846*	1.881*
		(1.757)	(1.801)
σNI			-9.376
			(-0.751)
ABNCI* σNI			-22.98*
			(-1.672)
Location		0.636	0.671
		(0.870)	(0.953)
σCI- σNI			-17.53
			(-0.904)
ABNCI*σCI-σNI*Location			
0.			-11.15
			(-0.880)
1.			-36.18***
			(-4.485)
σCI		-11.70	
		(-1.149)	
ABNCI *σCI * Location			
0.		-13.39	
		(-0.839)	
1.		-23.06***	
		(-3.085)	
Constant	1.909***	-0.897	-1.101
	(3.859)	(-1.561)	(-1.540)
Observations	438	436	436
R-squared	0.598	0.693	0.697
F	158.71	60.40	58.30
Prob > F	0.0000	0.0000	0.0000

Robust *t* statistics in parentheses

* $p < 0.1$, ** $p < 0.05$, *** $p < 0.01$

Table (2) displays the impact of different reporting locations of CI (i.e. comprehensive income statement and a statement of changes in equity) on stock prices. As shown by Table (2), the estimated regression models No., 1, 2 and 3 are significant at p-values<0.01, with R-squared of 59.8%, 69.3%, and 69.7% respectively. Disaggregating CI into its two components in Model No. (3) resulted in a slightly higher R-squared value compared to Model No. (2). Throughout all the estimated models, the coefficients of BVE, and ABNCI are positive and significant. In addition, the coefficient estimates for BVE are approximately equal to 1.0 in all the models which is consistent with Ohlson, 1995's predictions.

The findings demonstrate that the capital market pricing of CI volatility and the incremental volatility of CI over NI is conditional on the reporting location. Model No. (2) showed that the negative coefficient of *"ABCI *σCI * Location"* is significant only when the binary variable "*Location* "equals 1, which indicates that CI volatility strongly moderates the discounting of the abnormal earnings when CI is reported in a performance statement. Otherwise, when CI is reported in the statement of changes in stockholders' equity, the moderating impact of its volatility becomes insignificant. Similarly, Model No (3) displays that the significant negative coefficient for the interacting regressor "*ABCI *σCI- σNI* Location"* is conditional on "*Location*" equals 1, which illustrates that the incremental volatility of CI over NI captures risk factors that are priced in the capital market

only when OCI components are reported in performance statements. Hence, reject $\mathbf{H_{02}}$ and $\mathbf{H_{03}}$.

Summary and Conclusion

This research aimed to extend the prior literature that focuses on risk aspects of financial figures (i.e. volatility) and its consequences on capital markets. To achieve the research objectives, Pooled Ordinary-Least Square regressions (OLS) were estimated to examine the impact of the reporting location of comprehensive income (i.e., statement of changes in equity, or a separate performance statement) on investors' equity valuation in the capital market.

The findings showed that the comprehensive income of non-financial firms experiences more volatility than net income, and the differences in volatility level between CI and NI are significant. The reporting location significantly affects the market pricing of accounting information. The salient reporting of CI and OCI components facilitates investors' impounding of risk into stock prices. Investors are more likely to utilize risk-relevant information in CI volatility when these items are presented in a performance statement, rather than in the statement of changes in equity, which is consistent with the prior findings of Cao & Dong, 2020; Habiba, 2017; Hirst & Hopkins, 1998; Maines & McDaniel, 2000; Mita et al., 2020; X. Wang et al., 2019; Yao et al., 2022, while, contradicts the findings of Chambers et al., 2007; Lin et al., 2018; Schaberl & Victoravich, 2015.

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