# A CONTENT ANALYSIS OF THE COMPREHENSIVE INCOME EXPOSURE DRAFT COMMENT LETTERS

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## ABSTRACT

*This paper reports the results of a content analysis of comment letters submitted to the Financial Accounting Standards Board in response to the Board's Comprehensive Income Reporting Exposure Draft (FASB, 1996). Although comment letters are an integral component of the FASB's standard setting process, little is known about their content and the types of arguments made by letter writers. In this study, we categorize and analyze the arguments contained in these comment letters, focusing on how firms attempt to persuade the FASB. Our analysis documents the relative frequency of theoretical, outcome-oriented, and other arguments included in the letters. Despite the FASB's suggestion that comments focus on theoretical (conceptual framework) aspects of proposed standards, our analysis suggests that many of the arguments in the letters are non-theoretical, or outcome-oriented, focusing on anticipated negative effects for particular firms and industries from the Exposure Draft. Our findings help to provide a better understanding of the comment letter and standard setting process and provide insights into how letter writers*

**Research in Accounting Regulation, Volume 19, 53–79**
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**ISSN: 1052-0457/doi:10.1016/S1052-0457(06)19003-7**

*believe accounting information is used. The setting of our study is particularly interesting as the changes proposed in the Comprehensive Income Reporting Exposure Draft were strictly presentation-related and did not affect companies' reported net income or financial condition. Therefore, the contractual motivations related to debt covenants/or management compensation offered in previous research to explain comment letter writing, are mostly not present in this setting.*

## INTRODUCTION

Accounting standard setting is a complex process requiring systematic consideration of myriad opinions and viewpoints related to financial reporting alternatives. To help balance the competing interests of standard-setting constituents, the Financial Accounting Standards Board (FASB) follows an extensive 'due process' that is open to public observation and participation. An important component of this mechanism is the solicitation of letters commenting on proposed standards. Comment letters received in response to an exposure draft (ED) provide a publicly observable record of views presented to the Board in hopes of influencing the resulting standard. In this study, we analyze the content of comment letters submitted in response to the FASB's ED: *Reporting Comprehensive Income* (FASB, 1996), with an emphasis on the following research questions:

1. What types of arguments are included in the comment letters?
2. Are arguments in the letters associated with letter writers' industry affiliation?
3. To what extent are changes between the comprehensive income (CI) ED and *SFAS No. 130: Reporting Comprehensive Income* (FASB, 1997) consistent with arguments contained in the letters?

To answer our research questions, we develop a taxonomy of common arguments, systematically categorize the arguments contained in the letters, and relate letter writers' arguments to their industry affiliation to examine whether the arguments exhibit a systematic industry-specific component. We also explore how the arguments may have influenced the standard setting process by reconciling them to changes between the ED and the final standard.

We report three key findings. First, letter writers used a wide variety of arguments, including definitional, due process, and outcome-oriented

arguments, with outcome-oriented arguments related to external financial statement users being the most common. Second, the contents of the letters suggest a distinctly tailored aspect to the letter-writing process. Many respondents described company-specific circumstances (driven by industry affiliation) and speculated about how the ED would affect investors' perceptions of the operating results and level of risk for their company and others in the same industry. Finally, it appears that the FASB was responsive to certain positions held by letter writers. Although a causal connection cannot be made given other concurrent lobbying activities (public hearings, private meetings with the FASB), the changes made between the ED and the final standard (e.g., the elimination of a per-share requirement and the elimination of the requirement to report CI in a statement of financial performance, thus allowing CI to be reported in the statement of changes in equity) addressed the most common objections of the letter writers.[1]

Our content analysis complements existing studies that investigate the incentives of companies to lobby the FASB on a standard-setting issue (i.e., *whether* firms write comment letters). These existing studies look at a variety of factors (financial statement effects of proposed rule changes, bonus plans, covenants, firm size) and how they affect the likelihood of lobbying on proposed changes for pension accounting (Francis, 1987; Ndubizu, Choi, & Jain, 1993), oil and gas reporting (Deakin, 1989), consolidation accounting (Mian & Smith, 1990), accounting for other postretirement benefits (Schalow, 1995), and stock-based compensation (Dechow, Hutton, & Sloan, 1996). These studies focus on the decision to lobby (and to a lesser degree lobbying position), but do not investigate the detailed content of the letters, per se.[2] By analyzing the content of these letters and categorizing the detailed arguments therein, we look beyond the decision to lobby (whether to lobby) and focus on *how* firms attempt to persuade the FASB. In so doing, we gain insights about the types of arguments made in the comment letters, whether there are patterns of arguments among industry-affiliated groups, the degree of opposition to the ED, and how arguments are associated with changes in the final standard.

As a secondary contribution of this paper, we believe the existence of the CI comment letters (and the fact there was even a debate about CI) provides evidence about the perceived importance of *presentation format* of accounting information to capital market participants. In contrast to the majority of projects undertaken by the FASB, the CI ED included no new recognition or measurement requirements (i.e., it affected neither amounts reported in companies' balance sheets nor the measurement of net income). Therefore,

the contractual motivations (e.g., direct effects on debt covenant compliance and management compensation) used to explain comment letter-writing activity in previous studies did not exist for this ED.[3] However, almost 300 companies, including nearly half the Dow Jones Industrials, wrote letters on this seemingly narrow, presentation-oriented ED. This suggests that letter writers believed that the proposed changes were important and that presentation format (not examined in earlier comment letter studies) does matter.

The detailed content of the comment letters confirms the view that letter writers were concerned about the visibility of the new CI disclosures (leading to increases in perceived volatility), and the performance implications from the labeling and location of CI, elements of the presentation of CI. Interestingly, the behavioral nature of these arguments raised by letter writers (i.e., the emphasis on labeling, location, and format, all affecting visibility) is largely inconsistent with traditional economic models of market behavior (based on the assumption of market efficiency). However, it may be descriptive of the type of information that is used by groups of market participants, consistent with subsequent experimental evidence. Hirst and Hopkins (1998) and Maines and McDaniel (2000) find that where and how CI is disclosed, which incorporates differences in visibility and performance implications, affects professional analysts' valuation judgments and non-professional investors' perceptions of company performance/volatility, respectively. Hirst, Hopkins, and Wahlen (2004) find that CI disclosure format affects professional analysts' perceptions of interest rate risk. These experimental results are consistent with the letters writers' concerns about presentation format.

The debate that preceded the issuance of SFAS No. 130 continues to be relevant today, in light of the FASB's current joint project with the International Accounting Standards Board (IASB), *Financial Statement Presentation* (FASB, 2006a, 2006b), a project that revisits some of the conclusions reached during the debate that preceded the issuance of SFAS No. 130. The FASB and IASB have reached a tentative decision to eliminate the concession in SFAS No. 130 that allows the reporting of CI in a statement of changes in equity, and to instead require a single statement of performance, referred to as the "Statement of Earnings and Comprehensive Income."[4]

The remainder of the paper is organized as follows. First, we provide background information about the "comprehensive income" concept and outline the events that led to the submission of comment letters. Then, we discuss the overall position of the letter writers and the content of their

letters. We evaluate the comments, discuss the role of the letters in shaping the final standard, summarize the capital market implications of the comments, and end with concluding remarks.

## THE HISTORY OF COMPREHENSIVE INCOME IN THE STANDARD SETTING PROCESS

The FASB formally introduced the concept of "comprehensive income" to the accounting literature in *Statement of Financial Accounting Concepts (SFAC) No. 3: Elements of Financial Statements of Business Enterprises* (FASB, 1980) and defined it as "the change in equity of a business enterprise during a period from transactions and other events and circumstances from nonowner sources" (FASB, 1980). CI was intended to be a broadly defined measure of performance (i.e., net income was a subset of CI, but both were performance measures). As a practical matter, CI includes all changes in equity during a period except those resulting from investments by and distributions to owners.

The FASB did not formally propose reporting CI until the mid-1990s. Until that time, accounting standards were largely consistent with the all-inclusive (i.e., "clean surplus") concept of reported income, so the differences between CI and net income were relatively small.

Between 1981 and 1993, the FASB promulgated four new accounting standards that created new dirty-surplus gains and losses that bypassed the income statement and were reported directly in owners' equity.[5] These standards were seen as pragmatic solutions to the conflicting goals of reflecting current values in the balance sheet while trying to limit the effect that changes in these balance-sheet values would have on earnings and EPS. However, these standards were also regarded as lacking a sound conceptual basis because they shifted, in an ad hoc manner, the concept of "income" away from the all-inclusive approach toward a current operating performance approach. With the prospect of more items bypassing the income statement (e.g., cash flow hedges in the subsequently adopted derivatives standard (SFAS 133, FASB, 1998)), proponents of the all-inclusive income approach (e.g., AIMR, 1993) proposed that the FASB develop a CI reporting standard. As a result, the FASB added the CI project to its technical agenda in September 1995.

The FASB's deliberations on the CI project began in November 1995 and the FASB issued an ED of the proposed standard for public comment on

June 20, 1996. Key provisions of the proposed standard were:

1. CI should be divided into two display categories, net income and other comprehensive income, and the accumulated balances for each classification reported in a separate component of equity should be disclosed on the face of the statement of financial position, the statement of changes in equity, or notes accompanying the financial statements,
2. all items of CI recognized under present accounting standards should be reported in one or two statements of financial performance,
3. a total should be reported for CI, and
4. a per-share amount should be displayed for CI.

As part of its due process activities, the Board received 281 comment letters related to the ED and held public hearings in November 1996 for interested parties to comment further on the ED. Following the public hearings, the FASB resumed its deliberations on the ED during the first quarter of 1997. During these deliberations, which were completed in March 1997, the Board made significant changes to the ED.

Table 1 summarizes the key provisions of the CI ED and the final standard. Among the more important changes, the FASB eliminated the requirement that companies report a per-share amount for CI and relaxed its requirement that CI and its components be reported in one or two statements of financial performance. Although the final standard expressed a preference that companies report CI and its components in a statement of financial performance, the final standard merely required that CI be reported in a financial statement with the same prominence as other financial statements. The FASB approved the final standard and, on June 30, 1997, issued *SFAS No. 130: Reporting Comprehensive Income* (FASB, 1997).

***Table 1.*** Comparison of Comprehensive Income Exposure Draft to the Final Standard.

| Issue | Exposure Draft | Final Standard |
|---|---|---|
| 1. Location of comprehensive income report | In one or two statements of financial performance | In a financial statement with the same prominence as other primary financial statements |
| 2. Comprehensive income per share | Required | Not required |
| 3. Effective date | Fiscal years ending after 12/15/97 | Fiscal years ending after 12/15/98 |

## ANALYSIS OF COMPREHENSIVE INCOME COMMENT LETTERS

### *Overview of Comment Letters*

We obtained, coded, and analyzed 278 letters, comprising approximately 1,000 pages of comments, written in response to the CI ED.[6] The average letter was approximately three pages, with a range of 1–13 pages.[7] Letters written by financial statement preparers (as opposed to trade groups and audit firms) were typically signed by the CFO or the Controller. Compared to the number of comment letters generated by the FASB's first 100 accounting standards (Tandy & Wilburn, 1992), the CI ED generated more than twice the average number of letters and would rank among Tandy and Wilburn's (1992) top-10 standards in terms of letter volume.[8] The volume is striking because the proposed standard did not affect income recognition and measurement; it suggests, however, that financial statement preparers perceived that the proposed standard had important implications.

Table 2 summarizes the industry affiliation and overall position of letter writers. We rely on industry designations supplied by the FASB. The FASB divides respondents into seven groups: academics, banks, insurance, other financial services, industry, public accountants, and other. Because the arguments proposed by banks appeared to be associated with the responding banks' size, we further divided the banking group into small-bank and large-bank categories.[9,10] Financial services companies (including all banks and insurance companies) comprise the largest block of letter writers, generating 42 percent of the total letter volume. This is not surprising given that unrealized gains and losses on available-for-sale marketable securities is the largest component of other comprehensive income and the financial services industry has the largest holdings of these securities. Industrial companies comprise the other large block of respondents, generating 41 percent of the letter volume. Twenty-nine (11 percent) public accounting firms submitted comment letters, including all of the then "Big 6" firms. Another 4 percent of the letters were classified as "other" and included letters written by representatives of the financial statement user community. Only 2 percent of the letter writers were from the academic community. Overall, these results are consistent with Tandy and Wilburn (1992), who find that financial statement preparers write the most comment letters in terms of absolute numbers, public accounting firms write the most in proportion to their total population, and financial statement users and members of the academic community write the fewest letters.

**Table 2.** Constituents' Overall Position in Comment Letters.

| Source: | Frequency (%) of Overall Position[a] | | | | Total[b] | Representational Group/Position |
|---|---|---|---|---|---|---|
| | Support ED | Oppose ED | Partial[d] | No Opinion | | |
| Academics | 3 (50) | 2 (33) | – | 1 (17) | 6 (2) | American Accounting Association/Support[e] |
| Small banks[c] | – | 50 (91) | 3 (5) | 2 (4) | 55 (20) | America's Community Bankers/Oppose; Independent Bankers Association/Oppose |
| Large banks[c] | 2 (5) | 32 (84) | 4 (11) | – | 38 (14) | American Bankers Association/Oppose |
| Insurance | 1 (8) | 9 (75) | 2 (17) | – | 12 (4) | American Council on Life Insurance/Oppose |
| Other financial services | | 8 (67) | 3 (25) | 1 (8) | 12 (4) | |
| Industry (all non-financial) | 2 (2) | 89 (78) | 21 (18) | 2 (2) | 114 (41) | |
| Public accountants | 1 (3) | 18 (62) | 8 (28) | 2 (7) | 29 (11) | AICPA Ac SEC/Oppose AICPA Private Companies Practice Executive Committee/Oppose |
| Other | 5 (42) | 7 (58) | – | – | 12 (4) | |
| Total | 14 (5) | 215 (77) | 41 (15) | 8 (3) | 278 (100) | |

*Notes:*
[a]Percentages are calculated across the rows.
[b]Percentages are calculated down the column.
[c]Banks and Savings and Loans with $2 billion or more in assets were classified as "Large" banks.
[d]"Partial Support" letter writers generally supported the notion of increased disclosure, but opposed the manner in which the changes were to be carried out per the Exposure Draft.
[e]The letter from the AAA was written by the AAA's Financial Accounting Standards Committee, with the disclaimer that "the opinions expressed in this comment letter reflect the views of the individuals on the committee and not those of the American Accounting Association."

The FASB solicited comments on all matters contained in the ED, but requested that respondents address three specific issues: (1) whether they agreed with the decision to require a display of CI per share, (2) whether it was practicable to determine reclassification amounts for items that bypassed the income statement and went directly to equity, and (3) whether they agreed with the decision to display CI in either one or two statements of financial performance. Surprisingly, 27 percent of the letter writers, including a majority (65 percent) of the small banks, did not address any of these issues in their letters.

### *Content Analysis – Comment Letter Coding*

Weber (1990, p. 9) defines content analysis as a "research method that uses a set of procedures to make valid inferences from text." Content analysis is particularly useful for organizing text into manageable units, allowing research to be conducted. Content analysis may also be performed on archived text, so it has the advantage of being unobtrusive to the communicator (Weber, 1990). Disadvantages include the time and effort needed to develop a coding system to ensure reproducibility and reliability.

Content analysis has been used in accounting research mostly to analyze corporate communications, such as the letter to shareholders (Abrahamson & Amir, 1996; Smith & Taffler, 2000; see Jones & Shoemaker, 1994, for a review of content analysis studies in accounting). There are two general approaches to content analysis, quantitative or "form-oriented" analysis, focused on word counts, and qualitative or "meaning-oriented" analysis, focused on the meaning behind the words. Form-oriented analysis has the advantage of being more objective while meaning-oriented analysis has the advantage of providing richer insights into the text under analysis. Although our approach incorporates some elements of form-oriented analysis (looking for the presence of certain words or phrases), our approach is best characterized as qualitative, given the presence of subjectivity in our analysis.

We developed our coding system after reading the ED, the final standard, and an initial sample of 37 comment letters.[11] We performed two levels of coding of the comment letters. First, consistent with prior research on FASB comment letters (e.g., Tandy & Wilburn, 1992), we coded the letters according to (1) overall agreement with the ED and (2) industry membership. For overall agreement, we divided the letters into those that unilaterally supported, partially supported, unilaterally opposed, or expressed no

opinion about the proposed standard. Then we coded the comment letters according to the detailed arguments expressed in the letters.[12]

The data reported in this paper are based on coding performed by one of the authors. To test the reliability of the data, a doctoral student not involved in this project coded a random sample of 20 comment letters. For overall position, all high-level arguments, and all issues responses, the Kappa coefficients for intercoder reliability ranged from $K = .53$ to $K = 1$, and all were significant at conventional levels. For a random sample of detailed arguments, the Kappa coefficients for intercoder reliability ranged from $K = .38$ to $K = 1$, except for one detailed argument where $K = .22$, and all were significant at conventional levels, except for one detailed argument where $p = .12$.

Although the specific objections and arguments were numerous and varied, we were able to organize and catalog the arguments according to the taxonomy presented in Table 3. Most letters included a mix of arguments from various categories.

### *Analysis of Overall Position*

The data in Table 2 suggest that the ED was overwhelmingly opposed. With the exception of academics and "other" who were split almost evenly, opposition to the ED was high across all constituent groups. Overall, only 14 letter writers (5 percent) expressed unilateral support for the FASB's CI reporting proposal. In contrast, 215 (77 percent) letters expressed unilateral opposition to the proposal. Forty-one letter writers (15 percent) expressed partial support for the ED. These letters supported increased disclosure of dirty surplus items and/or the overall concept of reporting CI, but opposed how the CI disclosure would be presented in the financial statements, as outlined in the ED. Johnson & Johnson's letter provides a typical example of such a position:

> We ... applaud the Board's effort to implement changes that will provide users of financial statements with more meaningful information. While we concur with the ED that there is an increasing number of transactions that bypass the income statement, we do not feel that the proposed addition of a Statement of Comprehensive Income is the most appropriate solution to address this situation ... [Instead, we propose that] the accumulated balance for each material component of other comprehensive income be detailed solely in the Equity section of the balance sheet.

Positions taken by industry associations were largely consistent with the positions taken by their constituents. Banks were overwhelmingly opposed

***Table 3.*** Argument Taxonomy.

***Definitional arguments***-arguments focusing on the deficiencies of the current accounting model (i.e., one-sided, piecemeal fair value recognition), and whether comprehensive income (as operationalized) under the current model, and as defined in the ED, was in fact comprehensive and would be value-relevant as a performance measure. Letter writers also suggested that comprehensive income was not a good performance measure because it includes items for which the earnings process is not complete and reflects events outside of management's control.

***Scope arguments***-arguments suggesting that the comprehensive income exposure draft was a "quick-fix," lacking sound theoretical basis. Letter writers suggested that the comprehensive income debate should consider recognition and measurement of comprehensive income and whether income statements should follow the all-inclusive or current operating performance approach.

***Due process arguments***-arguments focusing on the FASB, without due process, changing the characterization of dirty surplus items from off-income-statement to their inclusion in a statement of performance. These letter writers argued that their earlier positions in the debates over SFAS Nos. 52, 80, 87, and 115 would have been different if comprehensive income reporting were required.

***Outcome-oriented arguments (effects on external financial statement users)***-arguments focusing on the reaction of investors and other users to the reporting of CI. Comments expressed concern that investors (1) will be confused by a new performance measure with which they had little experience, (2) might focus on the relationship and differences between comprehensive income and net income, and (3) might penalize firms with high comprehensive income volatility, believing there to be higher or increased risk. These comments also suggested that adding any disclosure to an already crowded income statement would lead to disclosure overload.

***Outcome-oriented arguments (internal effects)***-arguments focusing on firm-related effects from reporting CI, including the cost of implementation/compliance and how the new *accounting* standard could affect *operational* (hedging and investing) decisions.

***Other***-arguments not falling into one of the above categories were treated as other. These included concerns about other direct to equity items that were not identified in the exposure draft, tax effects and their presentation, the adverse effect on small banks, how the credibility of the FASB would be adversely affected by a CI standard, and the need for more examples. Although many letter writers included comments falling under the other heading, each particular other item was mentioned infrequently.

to the ED as were their representational organizations (American Bankers Association for both large and small banks, and America's Community Bankers and the Independent Bankers Association of America for small banks). Insurance companies were overwhelmingly opposed to the ED, as was the American Council on Life Insurance. Similarly, the AICPA's Private Companies Practice Executive Committee's opposition to the ED was consistent with the majority opinion of the CPA firms that submitted comment letters.[13]

***Table 4.*** Proportion of High-Level Arguments against Exposure Draft by Constituent Groups.

| Source: | Percent of Respondents Per Source | | | | | |
|---|---|---|---|---|---|---|
| | Definitional | Scope | Due Process | Outcome-Oriented (external users) | Outcome-Oriented (internal effects) | Other |
| Academics (N = 6) | 33 | – | – | 17 | – | 50 |
| Small banks[a] (N = 55) | 71 | 7 | – | 73 | 36 | 64 |
| Large banks[a] (N = 38) | 87 | 18 | 8 | 89 | 18 | 61 |
| Insurance (N = 12) | 92 | 17 | 8 | 92 | 8 | 58 |
| Other financial services (N = 12) | 75 | – | – | 58 | 33 | 17 |
| Industry (all non-financial) (N = 114) | 74 | 22 | 10 | 96 | 12 | 59 |
| Public accountants (N = 29) | 41 | 38 | 3 | 72 | 17 | 83 |
| Other (N = 12) | 41 | 8 | – | 58 | 8 | 58 |
| All comment letters (N = 278) | 70 | 18 | 6 | 83 | 19 | 60 |

*Note:*
[a]Banks and Savings and Loans with $2 billion or more in assets were classified as "Large" banks.

### *Analysis of Specific Arguments Raised in Comment Letters*

To better understand the specific nature of opposition to the proposed standard, we analyzed the detailed content of the letters. Table 4 summarizes the relative use of the argument categories described in Table 3.[14] Outcome-oriented external user arguments were raised by 83 percent of the respondents, more than any other category. Definitional arguments were the second most frequent, mentioned in 70 percent of the letters. Substantially fewer letter writers (under 25 percent) raised either scope, due process, or internal effects arguments.

The data in Table 4 suggest significant industry differences in the types of arguments raised. Public accounting firms were less likely to include definitional arguments and external user arguments, as compared to their counterparts in banking, insurance, and industry. Although scope arguments were raised in only 18 percent of the letters, 38 percent of public accounting firms included a scope argument. From their comments, it is

clear that public accountants were disappointed in the process that produced the ED. For example, the Arthur Andersen letter commented:

> Without addressing the issues … related to recognition, measurement and classification among net income, other comprehensive income and equity, requiring a statement(s) purporting to arrive at comprehensive income is a sham … the cart is certainly before the horse if we now require a statement(s) of comprehensive income before we address the recognition, measurement and classification issues.

In Table 5, we summarize some of the most frequently cited definitional, external user, and internal effects arguments.[15] In the paragraphs that follow, we discuss these arguments in greater detail.

*Definitional Arguments*

In the ED, the FASB outlined presentation-related requirements for its new CI measure, including how it would be labeled (''comprehensive income''), where it would be disclosed (in a statement of performance), and how it would be disclosed (with per-share information). In taking these positions, the FASB was elevating CI to a level of prominence previously accorded only to net income, and implying that CI was relevant for evaluating an entity's performance. The definitional arguments made by letter writers questioned whether CI, as defined, deserved this level of prominence as a performance measure.

The most common definitional argument (60 percent) was that CI, as currently operationalized and defined, is simply not a good performance measure and did not merit the prominence that the FASB was according it. A number of letter writers focused on the volatility of CI. Thirty-four percent observed that CI would be more volatile than net income, given current accounting rules regarding unrealized gains and losses. Pharmaceutical company Merck warned that there is the ''potential for significant fluctuations in comprehensive income and related per-share amounts resulting from unrealized market fluctuations,'' which might not be representative of a company's underlying performance.

Continuing with the volatility issue, 9 percent of letter writers observed that CI, combined with the current ''piecemeal approach'' for recognizing fair values in the balance sheet, could result in financial institutions reporting volatility in CI that is not representative of the institutions' underlying economics. With the present ''piecemeal approach'' to recognizing fair values, CI highlights the changes in fair values for only one class of assets. This is particularly troublesome for banks and insurance companies that hedge

***Table 5.*** Proportion of Detailed Arguments Against Exposure Draft by Constituent Groups.

| | Percent of Respondents Per Source | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | Academic | Small Banks [a] | Large Banks [a] | Insurance | Other Financial Services | Industry | CPA Firms | Other | Overall |
| | (N = 6) | (N = 55) | (N = 38) | (N = 12) | (N = 12) | (N = 114) | (N = 29) | (N = 12) | (N = 278) |
| **Definitional arguments** | | | | | | | | | |
| Poor performance measure | 17 | 58 | 76 | 92 | 75 | 63 | 28 | 33 | 60 |
| CI volatility | 17 | 33 | 50 | 75 | 16 | 36 | 7 | 17 | 34 |
| Volatility of CI misrepresents economics | – | 7 | 21 | 42 | – | 8 | – | – | 9 |
| Refer to rationale of earlier FASB decisions | – | 5 | 13 | 41 | 41 | 19 | 7 | 8 | 14 |
| Incomplete earnings process | – | 20 | 47 | 17 | 58 | 34 | 14 | – | 29 |
| Treatment of UGL | 17 | 15 | 29 | 58 | 25 | 11 | 3 | 8 | 16 |
| Hold to maturity | – | 24 | 3 | – | 8 | – | 7 | – | 6 |
| **Outcome-oriented arguments (external users)** | | | | | | | | | |
| Two income figures | 17 | 58 | 87 | 92 | 50 | 85 | 59 | 50 | 73 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Unsophisticated users | – | 33 | 24 | 17 | 17 | 20 | 17 | 17 | 22 |
| Information overload | – | 15 | 18 | – | 17 | 35 | 10 | 8 | 21 |
| Disclose CI in footnotes instead | – | 7 | 26 | 58 | 8 | 25 | 14 | 8 | 20 |
| Disclose CI in SCOE instead | – | 7 | 18 | 33 | 17 | 28 | 14 | – | 19 |
| **Outcome-oriented arguments (internal effects)** | | | | | | | | | |
| Companies will change operations to reduce reported volatility | – | 22 | 11 | 8 | 25 | 4 | 3 | 8 | 10 |
| Implementation cost is prohibitive | – | 16 | 8 | – | 8 | 10 | 14 | 8 | 10 |

the maturities of their fixed-rate financial assets and liabilities. In this case, a financial institution that is perfectly hedged appears to be more risky because only the changes in fair values of its fixed-rate available-for-sale marketable securities appear in other comprehensive income.[16] Large banks and insurance companies focused on this argument a great deal, referring back to the FASB's deliberations during the SFAS No. 115 debate:

> As the Financial Accounting Standards Board stated in paragraph 93 [sic] of SFAS 115 ... 'the Board concluded that reporting of unrealized changes in fair value for available-for-sale securities has the potential for significant earnings volatility that is unrepresentative of both the way enterprises manage their businesses and the impact of economic events on the overall enterprise, therefore, decided that those changes should be excluded from earnings.' To the extent that financial statement users confuse "other comprehensive income" with "earnings", this Exposure Draft's intent ... is contradictory to the expressed intent of SFAS 115." (Excerpt from comment letter from Financial Institutions Accounting Committee, a trade group that represents thrifts and banks.)

Fourteen percent of letter writers followed a similar approach, referring to the rationale of earlier FASB decisions regarding foreign currency, available-for-sale securities, or minimum pension liability.

Other letter writers (29 percent) focused on the fact that CI includes transactions for which the earnings process is not complete, as unrealized gains and losses are included in comprehensive *income* without meeting the criteria for revenue recognition. Along the same lines, 6 percent of letter writers (but 24 percent of small banks) noted that they truly intended to hold their available-for-sale securities until maturity, but classified these securities as available-for-sale, so they could sell securities in the rare event of an emergency, without violating the SFAS No. 115 (FASB, 1993) guidelines. In this case, any unrealized gains and losses recorded on the available-for-sale securities would reverse by the maturity date, making all unrealized gains and losses temporary. Although that argument may be popular, its theoretical merits are suspect (e.g., Willis, 1998).

*External User Arguments*

External user arguments focused on how investors and depositors would react to the new CI disclosures. The most common external user argument (mentioned by 73 percent of the letter writers) was that external users would be confused by the new, second "bottom line." Letter writers speculated on a number of ways that users could be confused. There were concerns that, in the first year of disclosure, users would be confused by the emergence of a second performance measure. There were concerns that users would spend too much time trying to understand the differences between CI and net

income, and that investors would perceive greater risk when looking at a more volatile CI pattern across years. Finally, there were concerns that, with net income proposed to be a sub-total and CI as the new bottom line in a statement of performance, wire services and users would shift their focus toward CI as the true measure of performance.

One observation from the concerns voiced by preparers is that they do not have faith in external users' abilities to extract value-relevant information in the financial statements. The concerns suggest that preparers believe that external users are functionally fixated, and standard setting bodies need to consider this when evaluating proposed accounting standards. Overall, concerns about unsophisticated external users were mentioned by 22 percent of the letter writers. Interestingly, small banks mentioned unsophisticated investors/users more often than large banks (33 percent to 24 percent) and suggested that depositors would be the most affected users of their financial statements.

Another external user argument was that investors would be confused by the presence of multiple performance measures, especially if CI was presented on a per-share basis on a statement of performance. For example, Genentech's letter commented:

> With (this and the EPS ED) in effect, the current financial reporting of one earnings per share disclosure for most companies would increase to four "measures of performance" ... all of this information on the statement of earnings overwhelms the user.

This concern with information overload seems disingenuous given the trend at that time among companies to provide supplemental, non-GAAP earnings figures in their earnings announcements (e.g., the so-called "cash earnings per share" and the multitude of "pro forma" earnings measures).

### *Internal Effects Arguments*

In light of concerns about external user reactions to CI disclosure, 10 percent of letter writers suggested that they or others in their industries would alter their operating policies in order to reduce accounting volatility, in order to "head off" a negative user reaction. Brewing giant Anheuser-Busch warned that it might have to curtail hedging activities (and become exposed, in an economic sense, to price fluctuations), in order to reduce CI volatility caused by hedging activities:

> ... the ED, together with its companion proposal on hedging will result in exaggerated balance sheet and income statement volatility ... should these proposals be adopted in present form, they may have the unanticipated result of encouraging companies to avoid certain sound risk management practices over reported earnings volatility.

Similarly, banks warned that they would be forced to change their operations (investment and hedging strategies) to reduce volatility in CI. Letter writers expressed concern that the accounting specified in the ED would begin driving their operating decisions. For example, the Independent Bankers Association of America claimed:

> To avoid potentially volatile changes in market value being reflected in comprehensive income … one alternative is to significantly shorten the maturity of 'available for sale' securities and forgo yield and the ability to maximize the financial performance of the institution … accounting standards are driving the financial and strategic decisions of community banks.

### *Reconciliation of Changes from the ED to the Standard as Issued*

As indicated in Table 4, 70 percent of letter writers made some type of argument about the definition of CI (with many going on to suggest negative implications for external users). Although these arguments were framed in terms of the definition of CI, the specific comments made by letter writers ("CI is poorly defined, given its proposed level of prominence" and "CI should not be this prominent, given its present definition") suggest that the central issue for these letter writers was not the definition of CI per se. Rather it was the poor "fit" between CI as defined (and operationalized) and its anticipated use by investors as a performance measure, if the ED was implemented.

Essentially, the letter writers believed that the changes required by the ED would affect whether and how much investors would use CI as a performance measure. This is particularly interesting in the context of this presentation only ED, where the definition of CI did not change and the information content provided to financial statement users also was not affected by the ED. Thus, any changes in investors' use of CI as a performance measure would have to be related to the presentation-related changes (labeling, location, and format) in the ED. Letter writers did, in fact, suggest that these changes would increase the prominence/visibility of CI and increase the likelihood that it would be used (inappropriately) as a performance measure.

Were these arguments valid? Recent experimental accounting research investigates the effect of format and location on investors' and analysts' judgments (e.g., Hopkins, 1996; Hirst & Hopkins, 1998; Maines & McDaniel, 2000; Hopkins, Houston, & Peters, 2000; Hirst, Jackson, & Koonce, 2003). Results from these studies suggest that format and location may influence the judgments of unsophisticated *and* sophisticated investors. Maines and

McDaniel (2000) hypothesize that differential presentation of CI leads to different performance signals and cognitive costs, which affect the weighting of CI information, and ultimately investor judgments.

These beliefs about investor behavior are evident in the specific suggestions made by letter writers for changes in the ED. These suggestions focused on labeling, location, and format of CI, with an eye toward decreasing the prominence/visibility of CI. Letter writers were overwhelmingly opposed to the requirement to disclose CI in a statement of financial performance. Twenty percent of letter writers suggested increasing the level of CI disclosure in the footnotes as an alternative. Nineteen percent of letter writers suggested disclosure in the statement of changes in equity. In the context of the efficient markets hypothesis, the location of reported CI within the financial statements seems to be a trivial issue. Nevertheless, letter writers' concerns about location suggest that they believe that location affects the perceptions of financial statement users.

As indicated in Table 1, the FASB eliminated the requirement to disclose CI in one or two statements of financial performance and replaced it with a requirement to disclose CI in a financial statement with the same prominence as other financial statements. As such, disclosure in a statement of changes in equity became acceptable, consistent with the stated wishes of 19 percent of letter writers. Indeed, this is the most common display choice exhibited by companies since the standard took effect.[17]

This modification became a significant point of contention among FASB members during the debate leading to the issuance of the final standard. Two members dissented from adopting the standard on the basis that "enterprises (could) display the items of other comprehensive income … with less prominence" as a result of this modification. Their stated goal in pursuing CI disclosure was to "significantly enhance the visibility of items of other comprehensive income" and "providing the required information in a statement of changes in equity will do little to enhance their visibility" (FASB, 1997).[18]

The other significant change between the ED and the final standard was the elimination of the requirement to provide disclosure of CI per share. As indicated in Table 6, the majority of all respondents (64 percent) unilaterally opposed presentation of CI per share. Large bank (84 percent), insurance (92 percent), and non-financial-industrial (84 percent) companies provided the highest levels of opposition. Interestingly, one extremely active letter-writing group, small banks, expressed little opposition to the per-share proposal (i.e., only 27 percent were opposed, while 71 percent expressed no opinion). The reaction by small banks is consistent with their community

*Table 6.* Constituents' Position on Reporting Comprehensive Income Per Share.

| Source: | Number (%) of Respondents | | | Representational Group/ Position |
|---|---|---|---|---|
| | For | Against | No Opinion | |
| Academics | 2 (33) | 1 (17) | 3 (50) | American Accounting Association/For |
| Small banks | 1 (2) | 15 (27) | 39 (71) | America's Community Bankers/Against; Independent Bankers Association/Against |
| Large banks | 1 (3) | 32 (84) | 5 (13) | American Bankers Association/Against |
| Insurance | 1 (8) | 11 (92) | – | American Council on Life Insurance/Against |
| Other financial services | – | 8 (67) | 4 (33) | |
| Industry (all non-financial) | 1 (1) | 96 (84) | 17 (15) | |
| Public accountants | 5 (17) | 10 (35) | 14 (48) | AICPA Ac SEC/Against AICPA Private Companies Practice Executive Committee/No Opinion |
| Other | 3 (25) | 4 (33) | 5 (42) | |
| Total | 14 (5) | 177 (64) | 87 (31) | |

banking focus and the fact that their financial statement users are most likely depositors who are more interested in the viability of the institution than in quarterly earnings. Of course, large banks, insurance companies and large industrial firms have quarterly earnings expectations to manage and are more sensitive to investors and analysts focusing on the "wrong" earnings per-share metric.

Some letter writers, though opposed to the CI proposal in general, considered the per-share requirement the worst part of the proposal, and were willing to "compromise" and accept disclosure of CI, as long as CI per share was not disclosed. Even though all of the information to compute CI per share was available, letter writers found the no per-share disclosure much more palatable. This suggests that a seemingly trivial presentation difference is not considered as such to financial statement preparers.

Overall, the changes between the ED and the final standard suggest that the FASB was open to suggestions about the ED and suggest that the views

expressed in the comment letters and in the public hearings influenced the final standard. The concerns about piecemeal measurement and unrepresentative volatility appear to have influenced the FASB. When respondents made specific suggestions for alternative disclosure, it appears that the FASB considered them and tried to reconcile them with the final standard.

## CONCLUSION

Prior comment letter-based research has focused on participation in letter writing and the relative position of letter writers. We extend this research and systematically code and analyze the content of comment letters written in response to the CI ED. Our analyses reveal that CI ED letter writers expressed a combination of outcome-oriented and definitional arguments, with smaller numbers of letter writers raising scope and due process arguments. Furthermore, there is a distinctly tailored aspect to the letter-writing process, as the arguments raised in many of the letters appear to reflect firm and industry-specific concerns. We also find a connection between the specific arguments raised and suggestions for alternative presentation made in the letters and the most significant changes between the ED and the final standard, suggesting that the FASB attempted to understand the positions of the letter writers, and that the content of the letters (along with other concurrent lobbying activities) may have influenced the final standard.

Our analysis is subject to certain limitations related to the content analysis methodology used. Krippendorf (1980) warns against the potential unreliability of self-applied investigator-developed recording instructions. We attempt to address reproducibility and reliability concerns with the use of a second coder, who was not otherwise involved in this study. Nevertheless, Weber (1990, p. 62) notes that "interpretation (of text) is in part an art." Accordingly, our results should be viewed with this limitation in mind.

Our setting is particularly interesting as the changes proposed in the ED were strictly presentation-related and did not affect companies' reported net income or financial condition. In the absence of the motives previously offered to explain comment letter writing, something else, such as concerns about the effect of presentation format, must have been at stake for nearly 300 self-interested parties to elect to write comment letters to the FASB.

There appears to be a general view among letter writers that external users (especially unsophisticated users) are functionally fixated and would be adversely affected by prominent disclosure of CI. Additionally, the willingness of some letter writers to "compromise" and accept increased disclosure of

CI in a different basic financial statement (the statement of changes in equity) suggests that letter writers believe that location of disclosure influences investor judgments.

Through its post-ED revisions to the CI standard in 1997, the FASB may have taken a politically expedient position on the performance statement/disclosure location issue. However, the price of political expediency is a dissatisfaction with reporting that continues to gnaw at the FASB nearly a decade later,[19] so much so that the performance statement/disclosure location issue has been reopened, with a tentative decision by the FASB and IASB to require disclosure of CI in a single statement of earnings and comprehensive income, perhaps leading to a new debate and a new wave of comment letters.

Some view the performance statement/disclosure location question as a non-issue. For example, Skinner (1999, p. 108) commented " … it is hard to see any economic justification for SFAS-130 … all the statement really does is to *display previously disclosed information in a different way*. The argument (supporting SFAS 130) implies that investors process information about recognized financial statement items differently depending on where these items are reported in the financial statements." Along the same lines, the Financial Accounting Standards Committee of the American Accounting Association wrote one of the few letters in support of the ED. In its letter, the AAA Committee downplayed the potential for user fixation on the CI items to be disclosed, "given the sophistication of capital markets."

Nonetheless, a growing body of experimental work indicates that disclosure format and location do matter (e.g., Hopkins, 1996; Hirst & Hopkins, 1998; Maines & McDaniel, 2000; Hopkins et al., 2000; Hirst et al., 2004). That is, financial statement users' judgments of risk and valuation do appear to be influenced by how and where performance is reported. These different, and as yet unreconciled, viewpoints suggest that further work is warranted.

## NOTES

1. For the decision to allow the reporting of CI in a statement of changes in equity, the FASB (as discussed in the "Background Information and Basis for Conclusions" for SFAS No. 130) noted that it was making this change in response to constituents'/Exposure Draft respondents' concerns about user confusion (FASB, 1997).

2. In an audit-standard-setting context, McEnroe and Martens (1998) and Geiger (1989) examine the content of comment letters written to the Auditing Standards Board. However, in both studies, auditing firms were the primary letter writers, with very little participation by preparers (7% and 10%, respectively). Relative to these

prior studies, this study contains a larger cross section of letter writers, particularly preparers, in an accounting-standard-setting context. Saemann (1999) examines comment letters written by four institutional interest groups (Financial Executives Institute, Institute of Management Accountants, Association for Investment Management and Research, American Institute of Certified Public Accountants) on 20 FASB accounting standards. However, Saemann (1999) focuses only on the patterns of positions taken by these four prominent interest groups. The emphasis in this study is on the breadth of arguments made and the grass-roots level lobbying in relation to this single ED.

3. Existing debt covenant and management compensation contracts are unlikely to be affected by the presentation-only changes in the CI ED. However, the new proposed disclosures may affect future contracts.

4. Since reaching the joint tentative decision, the IASB issued an Exposure Draft on March 16, 2006, allowing earnings and comprehensive income to be displayed in either one statement or in two statements (with no option to report comprehensive income in a statement of changes in equity). The comment period for the Exposure Draft expired on July 17, 2006. At its December 7, 2005 meeting, the FASB decided to defer issuing an Exposure Draft on comprehensive income reporting (FASB, 2006a). Instead the FASB will continue to review the issue (reviewing the comment letters on the IASB's ED) and is expected to issue a Preliminary Views document in the first quarter of 2007 (FASB, 2006b).

5. Specifically, these standards provided for dirty-surplus accounting for foreign currency translation gains and losses (SFAS No. 52, FASB, 1981), the change in the market value of a futures contract that qualified as a hedge of an asset reported at fair value (SFAS No. 80, FASB, 1984), the net loss recognized as additional pension liability but not yet reported as net periodic pension cost (SFAS No. 87, FASB, 1985), and unrealized holding gains and losses from investments in available-for-sale marketable equity securities (SFAS No. 115, FASB, 1993).

6. The FASB's listing of comment letters, dated November 21, 1996, included 277 letters. They received four additional letters after that date but prior to December 31, 1996. These four letters are included in our data set, as they were received prior to deliberations on the final Standard, bringing the total to 281 letters received. Two letters on the FASB listing were missing and were not analyzed. Comment letters from the AICPA Accounting Standards Executive Committee and the AICPA Private Companies Practice Executive Committee were treated as a single letter by the FASB. We treated these as two separate letters. Finally, we omitted two letters from students, who submitted comment letters as part of an accounting class assignment, for the final data set of 278 letters.

7. Because the November 1996 public hearing was scheduled to jointly address the comprehensive income and derivatives exposure drafts, some respondents wrote a single letter that included comments on both exposure drafts. For those letter writers who combined comprehensive income comments and comments on the concurrent derivatives and hedging ED into a single letter, only those pages devoted to comprehensive income were counted.

8. Tandy and Wilburn's (1992) analysis covers comment letters written in response to the first 100 FASB statements, issued between 1973 and 1988. The average number of comment letters for the 97 statements included in Tandy and Wilburn (1992) was

approximately 138 (calculated from Table 2, p. 53). The number of comment letters written for the statements in Tandy and Wilburn's "Top 10" ranged from 1,435 to 269 (Tandy & Wilburn, 1992, Table 1, p. 52). We speculate that the reason for the high number of comment letters for the CI ED was the broad-based effect of the changes, while also having a particularly significant effect on two well-organized industries (banks and insurance). Additionally, the relatively high number of comment letters for this ED may be due to systematic changes in the level of lobbying between 1988 and 1996. For a more contemporaneous comparison, the FASB received over 1,700 comment letters (Dechow et al., 1996) related to the stock-based compensation proposal that preceded the issuance of SFAS No. 123 (FASB, 1995).

9. We designated large (small) banks as those institutions with greater (less) than $2 billion of assets.

10. We are interested in whether comment letters are tailored to reflect letter writers' individual firm circumstances. It is our belief that arguments made in a comment letter will be most related to that firm's exposure to dirty surplus items, which is determined by the rough composition of a firm's balance sheet, which in turn is driven by industry affiliation. Accordingly, we categorize firms based on industry affiliation (and size, for banks only). We do not perform a firm-level analysis of comment letter arguments.

11. Our coding system was based on an initial holdout sample of 37 letters. The results reported in this paper reflect the combined data from all of the comment letters (holdout and otherwise).

12. Given the preponderance of comment letters that either objected to the ED in general or objected to the specific requirements of the ED, and our interest in understanding how the ED evolved into the standard as issued, our analysis focuses on those arguments that were criticisms of the ED, not those arguments in support of the ED.

13. We cannot be sure whether the matched opinions were the result of constituents first holding individual viewpoints and then aggregating these viewpoints into their association's comment letter, or were the result of associations developing an opinion first and then pushing that opinion down to members and encouraging them to submit individual comment letters. Interestingly, we observed that Ernst & Young LLP and six of its audit clients had very similar letters, right down to the use of quotation marks and parentheses. However, with the exception of the Ernst & Young LLP and client letters, our observations were that the comment letters were individualized in their wording and tone and any commonalities in content were due to common circumstances, and not because these were form letters.

14. Thirty-three percent of letter writers observed that no new information would be provided as a result of the Exposure Draft. We do not include this comment in our analysis. Our analysis focuses on those comments that discussed potential harm from proposed CI disclosures.

15. While there were different types of arguments falling under the definitional argument, external financial statement user argument, and internal effects argument umbrellas, there was only one type of scope argument and only one type of due process argument.

16. Supporting this claim, recent experimental evidence (Hirst et al., 2004) finds that professional analysts (specializing in banks) are more likely to misperceive interest rate risk when fair value is reflected in income on a piecemeal basis (consistent

with comprehensive income) than when fair value is fully reflected in income. However, the reality is that banks may not be as perfectly hedged as they claim to be. The claim by banks that the volatility of comprehensive income is misleading because of the piecemeal approach to fair value reporting is contradicted by subsequent research (Hodder, Hopkins, & Wahlen, 2006) that finds that the volatility of full fair-value income is more than three times that of comprehensive income (for a sample of US banks from 1996 to 2004).

17. At least one major accounting firm provided clients with guidance suggesting that elements of other comprehensive income be disclosed in the statement of changes in equity. Specifically, Coopers and Lybrand L. L. P. (1997) observed, "In response to constituents' concerns, the (FASB) decided not to require companies to display … comprehensive income and its components in a statement of financial performance. *The decision permits an enterprise to utilize a statement of changes in equity to display the components of comprehensive income in lieu of a statement of financial performance …* " (emphasis added).

18. Experimental research in accounting supports this view. In an experiment using financial analysts, Hirst and Hopkins (1998) asked analysts to make a stock price judgment and were given information about earnings management activities using available-for-sale securities (an other comprehensive income item), either on an income statement, a statement of changes in equity, or in the footnotes. Stock price judgments and general financial-performance judgments were affected by the location of the CI report. Maines and McDaniel (2000) report similar findings with unsophisticated investors. Similarly, on the preparer side, Hunton, Libby, and Mazza (2006) find that preparers are more likely to engage in earnings management involving available-for-sale securities when CI is reported in a statement of changes in equity (less transparent presentation of comprehensive income) than when CI is reported in a statement of performance (more transparent presentation). In a related archival study, Lee, Petroni, and Shen (2006) find that insurance companies they identify as engaging in cherry picking of their available for sale securities portfolio and potential earnings management are more likely to choose to report CI in the statement of changes in equity.

19. In addition to acting on dissatisfaction with CI reporting, the FASB's activism on this issue may also reflect a new emboldened attitude toward standard setting in the post-Enron era.

## ACKNOWLEDGMENT

We appreciate the helpful comments of Ruth Ann McEwen, Gary Previts (the editor), and two anonymous reviewers. We are also grateful for the research assistance of Lynette Wood.

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