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Making Sense of Other Comprehensive Income

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Stakeholders who focus on a long-term performance measure may use comprehensive income as a surrogate for future profits, writes **PEARL TAN**

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Q: How is other comprehensive income different from net income? How may SME managers and stakeholders use the information on other comprehensive income to evaluate the business?

A: The income statement is often seen as the "report card" of a company with net profit being a key performance measure. A more recent and less familiar income measure relates to "comprehensive income".

Comprehensive income is the sum of net income and "other comprehensive income" or OCI for short. All companies, including SMEs, are likely to have a measure of OCI in their financial statement at some point in time. It is important for owners and managers of SMEs to understand the components of OCI and how OCI will affect reported equity and net assets.

In a nutshell, OCI comprises income items that bypass net income as required or permitted by accounting standards. In other words, they have the same characteristic of items included in net income – that is, they increase or decrease the net assets of the business and they arise from "non-owner" transactions.

However, they are reported separately from net income in accordance with accounting standards. There are no clear principles to explain the separation of OCI from net income and why some items are designated as OCI. However, one can infer that OCI items are mainly longer-term unrealised gains and losses. Their separation from net income shields the latter from period-to-period volatility. Eventually, some but not all OCI items will be reclassified to net income when an event occurs.

The reporting of comprehensive income is intended to improve transparency of income reporting. Prior to the mandatory reporting of comprehensive income, stakeholders had to track income items that are separately reported in the income statement and others that are reported in the statement of changes in equity.

The accounting standards that govern financial reporting in Singapore are the Singapore Financial Reporting Standards (SFRS). However, an SME that qualifies as a small entity for financial reporting is also permitted to use the SFRS for Small Entities. Both the full SFRS and the SFRS for Small Entities have requirements governing the type of income items that are reported as OCI. This article will consider three OCI items that are more commonly reported by Singapore companies.

One commonly reported OCI item is the revaluation surplus relating to property, plant and equipment (PPE). The full SFRS permits companies the choice of measuring their PPE at either cost or revaluation.

If you choose the revaluation basis, you will have to apply the basis consistently to all items within a grouping of assets of a similar nature. Revaluation surplus that is not a reversal of a prior deficit will be taken to OCI. However, a deficit is taken to net income. In times of rising asset prices, your financial statements will report higher assets and higher equity. However, you should note that your depreciation expense will also be higher because of the higher asset base.

The revaluation basis may enable an SME to reveal more of the value of its PPE on its balance sheet. However, an SME should consider the measurement choice carefully. Changes to accounting policy choice are not expected to be made frequently and must be justified. While the full SFRS permits the choice of the cost or revaluation basis, the SFRS for Small Entities permits the use of the cost basis only.

Another OCI measure relates to translation gains or losses arising from foreign operations. Many Singapore companies, including SMEs, have foreign subsidiaries, associates and joint ventures. Translation of these foreign operations will result in gains or losses that are recognised in OCI. For example, when the Singapore dollar appreciates relative to the currency of a foreign subsidiary, the Singapore parent will record translation losses on its foreign investments. These gains or losses are long-term in nature and will be taken to net income only when the foreign investments are sold. The OCI balance provides information to stakeholders and to managers of SMEs on the extent of their companies' exposure to exchange risks of foreign investments. The OCI balance is an estimate of exchange gains or losses on the future repatriation of earnings or the ultimate disposal of a foreign operation, given current market conditions. The SFRS for Small Entities has a similar requirement to recognise translation gains or losses on foreign operations in OCI.

A third example of an OCI item reported under the full SFRS, but not the SFRS for Small Entities, is the change in fair value of an Available-for-Sale (AFS) security. This category of financial assets relates to non-derivative and non-trading financial assets. The OCI balance at reporting date represents unrealised gains or losses on an AFS security (however, a loss which is impairment in nature is taken to income). A positive OCI balance signals expected profits on the future sale of the security based on current market conditions.

This article considers three types of OCI items reported under the full SFRS. Stakeholders of an SME may use the information on OCI to assess risks and to estimate future cash flows from the reported unrealised gains or losses. Whether external stakeholders focus on net income or comprehensive income or both depends on the stakeholders' evaluation objectives. Stakeholders who focus on a long-term performance measure may use comprehensive income as a surrogate for future profits.

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