Value Relevance of Earnings Component in the Financial Industry

Retno Yulianti¹, Zuhrohtun¹
¹Department of Accounting, Faculty of Economics and Business, Universitas Pembangunan Nasional "Veteran" Yogyakarta, Indonesia

Abstract

PSAK No. 1 of 2009 is enforced from 2011 onwards. The presentation of the income statement changes to a comprehensive income statement consisting of operating income, non-operating income, net income, other comprehensive income (OCI). The purpose of this study was to test the value relevance of OCI and other components of earnings that were tested based on the relationship between OCI and stock prices in the financial industry. The population in this study are all companies listed on the Indonesia Stock Exchange which are included in the financial industry in 2016–2019. Based on the determination of the sample using the purposive sampling method, the research sample obtained was 335 firm years. The data is processed using OLS regression. This study indicates that OCI, non-operating income, and comprehensive income have value relevance which is indicated by the negative effect of OCI on stock prices and the positive effect of non-operating income and comprehensive income on stock prices. However, operating income and net income have no effect on stock prices.

Keywords: value relevance, non-operating profit, comprehensive income, other comprehensive income (OCI), stock price

INTRODUCTION

PSAK No. 1 of 2009 is enforced from 2011 onwards. The accounting standard refers to IAS 39, which requires the use of fair value accounting for certain types of financial instruments and includes gains or losses resulting from changes in fair value in the income statement. Therefore, the presentation of the income statement has changed to a comprehensive income statement consisting of operating income, non-operating income, net income, other comprehensive income (OCI). OCI reports unrealized gains and losses (URGL) due to changes in the fair value of assets or debts owned by the company.

OCI is not new because prior to 2011, OCI had actually been reported in the statement of changes in equity. The difference in the location of the presentation is based on the change from the dirty surplus theory approach to the clean surplus theory approach. The net surplus theory states that all changes in assets and liabilities that are not related to transactions with owners can be explained using the income statement (Feltham & Ohlson, 1995). Although not new, testing the value relevance of OCI and other components of earnings after changes to PSAK No. 1 becomes important because it is to find out which profit information is relevant for investor decision making.

Value relevance is the relationship between financial statement numbers and stock prices or returns. The difference in the presentation of the OCI presentation location raises a debate about the relevance of the presentation of comprehensive income. According to (Biddle & Choi, 2006), proponents of comprehensive income statements (supporting all-inclusive) state that clean surplus, which only
describes net income and dividends, is internally consistent, less supportive of manipulation, and more in line with valuation theory. Meanwhile, non-supporters of the comprehensive income statement (supporting current operating performance) state that earnings should be summarized from transitory effects to describe current operating performance, and managers will take out items that they cannot control. Park (2018) also states that the all-inclusive concept is more useful for making economic decisions for market participants than the current operating performance concept.

Testing the relevance of OCI after the demand for comprehensive income needs to be done because the existing empirical findings have not shown anything consistently. Chambers et al. (2007) prove that OCI is appreciated by investors when it is on the statement of changes in equity because investors are familiar with the location of the predominant OCI reporting. Meanwhile, Lin, Ramond, & Casta (2007) found that total OCI has a relevance value exceeding net income in many countries. In fact, the two components of OCI, namely foreign currency translation adjustments and unrealized AFS securities gains and losses, have a higher relevance value than other components (Chambers et al., 2007). Jones and Smith (2011) found different things, comprehensive income and OCI were less predictive than net income. The less predictive value will reduce the value relevance of the OCI.

In Indonesia, Yulianti et al. (2019) found that comprehensive income has more value relevance than net income. Darsono (2012) and Mita et al. (2017) found that OCI has value relevance. However, Widiastuti and Safira (2018) found that OCI information has no value relevance for creditors. Assets or debts referred to in changes in fair value reported in OCI may be owned more by certain industries, such as the financial industry. Users of financial statements may pay more attention to OCI information in certain industries that have larger financial assets than other industries. Thus, it is necessary to test the relevance of OCI in the financial industry group. In addition, there are still few studies that examine the value relevance of the OCI component. Based on the research gaps that have been stated above, the purpose of this study is to examine the relevance of the value of OCI and other components of earnings that are tested based on the relationship between OCI and stock prices in the financial industry.

LITERATURE REVIEW

Value Relevance of income and OCI

Earnings are a function of the company's financial performance, and this function represents an accounting system that converts unobservable financial performance into observable earnings figures (Dechow, Ge, & Schrand, 2010). Therefore, earnings figures cannot perfectly describe the company's financial performance. How well the earnings describe, the actual financial performance is approximated by the quality of earnings. Earnings quality is a concept that does not have a general definition in the literature. Schipper and Vincent (2003) define earnings quality as to how far reported earnings fully represent Hicksian income, including changes in net assets other than transactions with owners. The definition of earnings quality is also explained by Bellvary et al. (2005), which states that earnings quality is the ability of reported earnings to represent the company's actual earnings and to predict future earnings. Earnings quality also describes the stability, persistence, and low variability of reported earnings.

Measuring earnings quality is important because earnings are usually used to compose compensation or debt agreements. Contract decisions based on low-quality profits will lead to unexpected welfare transfers, for example, overstated earnings are used for managers' performance indicators, then compensation is also overstated. From an investment perspective, low earnings quality is undesirable because it signals poor resource allocation, i.e., it is inefficient because it diverts potential projects with less profitable projects.
Earnings quality can be seen from 4 perspectives: persistence, volatility, ability to predict cash flow from operating activities and net income in the future, and its relationship with stock returns (Dechow & Schrand, 2004). The relationship between financial statement numbers and stock prices or returns is often referred to as value relevance. Value relevance is the ability of financial statement information to capture information that affects firm value (Collins et al., 1997; Francis and Schipper, 1999) or share value (Hellström, 2006). High earnings quality provides information about the company's financial performance that is relevant for making certain decisions.

Previous Research Review

The relevance of earnings figures or the relationship between earnings announcements and stock prices was first proven by Ball and Brown (1968). Furthermore, this research becomes a guide for various studies that consistently find the content of earnings information that is relevant to making decisions. However, along with the dynamic business environment, standards regarding the presentation of income statements have also changed. Therefore, research on the information content of earnings is growing. Lipe (1986) found that variations in stock returns of industrial and commercial companies are explained better by the earnings component than by aggregate earnings. He found that each component provides information that complements the aggregate earnings information, and if the earnings component information is combined into one aggregate profit figure, the information will be lost. In contrast to Lipe (1986), Jaggi & Zhao (2002) prove that earnings component information is more relevant for investment decisions after the implementation of SFAS 115.

After applying the presentation of comprehensive income in accordance with SFAS 130, the results of the study prove that net income dominates total comprehensive income (Biddle & Choi, 2006; Kabir & Laswad, 2011) in explaining stock returns. Chambers et al. (2007), which more specifically examines the benefits of presenting other comprehensive income, proves that the two components of other comprehensive income, foreign currency translation adjustments and unrealized gains or losses from available-for-sale securities, have a higher value relevance than the other components. Likewise, Lin et al. (2007), which uses samples from various countries, proves that total other comprehensive income has a relevance value exceeding net income in many countries, but comprehensive income has less relevance than the other operating income and net income. Pinto (2005) also found that the OCI component in the form of foreign currency translation adjustments had value relevance for a sample of companies in America between 1991 and 1996. The relevance of the OCI value after the mandatory presentation of OCI was also found by Yousefinejad, Ahmad, & Embong (2017) and Park (2018).

The results of research that do not support the usefulness of the comprehensive income statement were found by Dhaliwal, Subramanyam, & Trezevant (1999) and Doukakis (2010). Dhaliwal et al. (1999) conclude that comprehensive income is not more strongly associated with stock returns or is not better at predicting cash flow or earnings than net income. Doukakis (2010), who uses the phenomenon of IFRS adoption, proves that the adoption of IFRS, which requires the presentation of comprehensive income, does not increase the persistence of earnings and profit components systematically for future profitability. On the other hand, the persistence of operating and non-operating earnings is lower, as well as lower explanatory power after the adoption of IFRS.

Hypothesis Development

OCI includes items related to the valuation of the fair value of assets and liabilities. For information, OCI also faces usability issues considering the trade-off between relevance and reliability. Information is
said to have benefits if it can meet these two qualitative characteristics, but they cannot be emphasized together. The International Accounting Standards Board (IASB) states that rather than historical cost accounting reliability, fair value relevance is considered to be a more emphasized qualitative characteristic. Relevance is more important because relevant financial information can differ in the decision whether it has predictive value or confirmatory value, or both (Park, 2018). Financial information will have predictive value if the information can be used as input in predicting future performance. Meanwhile, financial information will have confirmation value if the information provides feedback, confirms, or changes the previous evaluation. Predictive value and confirmative value are related; if the information has predictive value, it often also has confirmative value.

For users of financial statements, understanding the main operating activities as a producer of company performance is important. However, OCI has the potential to increase or decrease net income. A positive total OCI will improve the reported net income. On the other hand, a negative total OCI will reduce net income and even worsen the reported net loss. Investors will respond positively if reported comprehensive income has predictive value, whether it is low or high profit. OCI in the form of unrealized gains or losses resulting from changes in the fair value of assets and debt. Unrealized gains or losses can be managed in amount through real activities, for example, the sale of financial assets that are included in the available-for-sale group. Thus, OCI information is a signal because companies that do not perform well will not fool the market with large unrealized profits. Companies will not dare to report high OCI, which will cover low net income and result in high total comprehensive income if future performance is poor. Yousefenijad (2017) uses the theoretical basis of the efficient market hypothesis stating that OCI information will have a positive effect on stock prices because OCI information affects investors’ ability to make more effective decisions. Thus, the hypothesis of this study is as follows.

H1: Operating income has a positive effect on stock prices.
H2: Non-operating income has a positive effect on stock prices.
H3: Net income has a positive effect on stock prices.
H4: OCI has a negative effect on stock prices.
H5: Comprehensive income has a positive effect on stock prices.

RESEARCH METHOD

Population and Sample

The population in this study are all companies in the financial industry listed on the Indonesia Stock Exchange in 2011-2020. Determination of the sample using the purposive sampling method obtained 335 companies.

Research Variable

The dependent variable in this study is the stock price. The stock price is the closing price for trading shares of a company on a certain date. In this study, stock prices are used three months after the end of the financial reporting period, which is generally December 31 (Yousefenijad, 2017). If the date falls on a Saturday or Sunday, the following date is used. The share price is measured using the price per share. The independent variables in this study are operating income (OI), non-operating income (NonOI), net income (NI), other comprehensive income (OCI), and comprehensive income (CI).

The research model is as follows:

\[ P_t = \alpha_0 + \alpha_1 OI_{it} + \alpha_2 NonOI_{it} + \alpha_3 NI_{it} + \alpha_4 OCI_{it} + \alpha_5 CI_{it} + \varepsilon_t \]
In this case; Pit is the share price per share, OIt is operating income scaled by the number of shares outstanding. NonOIt is non-operating income scaled to the number of shares outstanding, NIt is net income scaled by the number of shares outstanding shares, OCIIt is the total comprehensive income scaled by the number of shares outstanding, and CIIt is the comprehensive income scaled by the number of shares outstanding.

FINDINGS AND DISCUSSION

Descriptive statistics

The statistical description of the data in this study can be seen in the following table:

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Median</th>
<th>SD</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price (P)</td>
<td>1723.70</td>
<td>448</td>
<td>3.414</td>
<td>50</td>
<td>27400</td>
</tr>
<tr>
<td>Operating Income (OI)</td>
<td>0.000115</td>
<td>7.81E-06</td>
<td>0.000290</td>
<td>-0.00055</td>
<td>0.002893</td>
</tr>
<tr>
<td>Non Operating income (NonOI)</td>
<td>4.06E-06</td>
<td>0.000000</td>
<td>7.90E-05</td>
<td>-8.98E-05</td>
<td>0.001389</td>
</tr>
<tr>
<td>Laba Bersih (NI)</td>
<td>0.001312</td>
<td>1.88E-05</td>
<td>0.016758</td>
<td>-0.000490</td>
<td>0.284484</td>
</tr>
<tr>
<td>Other Comprehensive Income (OCI)</td>
<td>-6.08E-06</td>
<td>4.35E-07</td>
<td>0.000193</td>
<td>-0.002402</td>
<td>0.000790</td>
</tr>
<tr>
<td>Comprehensive Income (CI)</td>
<td>0.000118</td>
<td>2.19E-05</td>
<td>0.000298</td>
<td>-0.001033</td>
<td>0.001987</td>
</tr>
</tbody>
</table>

From Table 1, it can be seen that the average non-operating profit is smaller than the operating profit. Likewise, OCI is smaller than net income.

Hypothesis Testing Results

The results of hypothesis testing can be seen in the following table:

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Std. Error</th>
<th>t-Statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>C</td>
<td>762.9372</td>
<td>104.9915</td>
<td>7.266655</td>
<td>0.0000</td>
</tr>
<tr>
<td>OI_LEMBAR</td>
<td>-990057.6</td>
<td>1220279.</td>
<td>-0.811337</td>
<td>0.4178</td>
</tr>
<tr>
<td>NonOI_LEMBAR</td>
<td>1251293.</td>
<td>626430.6</td>
<td>1.997496</td>
<td>0.0466</td>
</tr>
<tr>
<td>NI_LEMBAR</td>
<td>3146634.</td>
<td>2329364.</td>
<td>0.013509</td>
<td>0.9892</td>
</tr>
<tr>
<td>CI_LEMBAR</td>
<td>8861571.</td>
<td>2031084.</td>
<td>4.362977</td>
<td>0.0000</td>
</tr>
<tr>
<td>OCI_LEMBAR</td>
<td>-4542658.</td>
<td>2229305.</td>
<td>-2.037702</td>
<td>0.0424</td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.469326</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F-statistic</td>
<td>60.07761</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>335 firm-years</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

From Table 2, it can be seen that non-operating income (NonOI), other comprehensive income (OCI), and comprehensive income (CI) affect stock prices at a significance level of 5%. OCI has a negative effect because OCI reports unrealized profits. The higher the unrealized profit, the lower the investor's
response because investors do not like uncertainty. Thus the OCI responded negatively. In contrast to OCI, investors responded positively to NonOI and CI because NonOI is profit that has been realized, while CI contains realized profit and unrealized profit.

The results of this study support the findings of Yousefinejad, Ahmad, & Embong (2017) and Park (2018), who found that the OCI has value relevance after the mandatory presentation of OCI. By proving that comprehensive income has value relevance, this study also confirms the findings of Park (2018), who states that the all-inclusive concept is more useful for making economic decisions for market participants than the current operating performance concept.

CONCLUSION AND FUTURE RESEARCH

The results of this study prove that OCI, non-operating income, and comprehensive income have value relevance. This shows that information on OCI, non-operating income, and comprehensive income are used to make investment decisions by investors.

This study has limitations, and it has not considered the effect of the enactment of PSAK 71, which is effective in 2020. Therefore, for further research, it is better to consider the effect of the implementation of PSAK 71 by testing the relevance of the OCI value before and after the enactment of PSAK No. 71.

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