

Comprehensive Income Transparency and Investor's Rational Expectations Formation*

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Abstract

In the past Japanese accounting regimes before the introduction of a statement of changes in net assets in a complete set of financial statements in the fiscal year ending in March 2007, Other Comprehensive Income (OCI) items are not presented in the financial statements anywhere. This opaqueness of comprehensive income information might hinder investor's rational expectations formation for future income (hence, might hinder efficient price formation in the capital markets). In this paper, using Mishkin's [1983] two equations framework, we tests whether stock prices fully reflect past information of comprehensive income components (i.e., net income and OCI items) for future income (i.e., net income or comprehensive income) and shows that, for the pooled sample and the subsample of low market value of equity, the persistence of some OCI items are significantly undervalued. This result suggests that financial reporting opaqueness causes stock market mispricing because of investors' misunderstanding of financial reporting information, particularly in the low capitalized firms whose information is considered to be scarcely produced in the capital markets.

We believe that, in terms of financial reporting transparency (defined in Barth and Schipper [2008]), the mechanism of recycling should be abandoned and all entities should present all components of comprehensive income in a single statement of financial performance. However, provided that current political environment might not permit such a radical evolution, we believe that, for the time being, constituents in

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Japan should continue the work of the adoption of International Financial Reporting Standards (IFRSs) in Japan and the convergence of Japanese GAAP and IFRSs so as to ensure the acceptance of the current international approach, that, retaining the mechanism of recycling, presents all components of comprehensive income in either one or two statement(s) of financial performance, in Japan.

Keywords: Financial statement presentation, Comprehensive income, Financial reporting transparency, Mishkin test