

CHAPTER 1: INTRODUCTION

According to 2002 Norwalk Agreement signed by U.S. Financial Accounting Standards Board (FASB) and International Accounting Standards Board (IASB) (collectively, “*the Boards*”), the Boards acknowledged that the convergence of accounting standards is an ultimate end in financial reporting practices. By 2009, the divergence of accounting standards and the needs for reconciliation and accounting adjustments resulting from discrepancies in accounting standards should not remain. The Boards mutually devote their efforts and resources in developing *high quality* and compatible accounting standards for both domestic used and international financial reporting. By “*high quality*”, the Boards aim for the financial statements that can improve the ability of financial statement users (especially, investors and creditors) to (a) understand an entity’s present and past financial position, (b) understand past operating, financing, and other activities that trigger the changes in financial position, and (c) be able to utilize the financial information in conjunction with information from other sources to assess the amounts, timing, and uncertainty associated with future cash flows.

To achieve the convergence of accounting, the financial statement presentation (FSP) project is currently on an active agenda of and jointly determined by the Boards. The proposed working principles of the financial statement presentation resulting from the Boards’ deliberations state that the financial statements should (a) *depict a cohesive financial representation of a given firm*, (b) *present financing activities separately from its business and other activities*, (c) *display disaggregated financial information by function and by nature*, (d) *depict an ability of a given firm in satisfying financial commitments and obligations*, and (e) *describe the measurement basis applied in preparing financial statements*.

From the aforesaid proposed working principles, the Boards are currently exploring and proposing a new format of financial statements (hereafter, “*working format financial statements*”). They propose that a complete set of financial statements should comprise (1) statement of financial position, (2) statement of comprehensive income, (3) statement of cash flows, and (4) statement of changes in

owners' equity. Except for statement of changes in owners' equity, the major sections on the face of financial statements should be presented cohesively and should be categorized as *Business* (further disaggregated into operating and investing), *Discontinued Operations*, *Financing*, *Income taxes*, and *Equity* (if applicable). Not only the major sections are proposed, but also the totals and subtotals in each statement are revised. Moreover, the level of details presented on the face of financial statements is expected to be expanded. Due to these changes, some of the traditional financial ratios and operating performance measures used in financial analysis cannot be easily determined. The proposed changes in the presentation format are considered to be major and vital. The impact of the proposed changes on financial statement users' judgments and decisions and the information usefulness of the proposed format financial statements are yet to be seen. This motivates my study.

The purpose of this study is to examine the effect of proposed format financial statements on the investors' operating performance evaluation judgments. Even though the proposed format financial statements amend the presentation requirements of the whole set of financial statements, the focus of this paper is only on the impact of financial performance reporting (i.e. statement of comprehensive income or income statement) on investors' operating performance evaluation judgments. Aiming to provide empirical evidence on some of the benefits of the proposed working principles, I study whether the differences in the presentation format (specifically, the proposed classifications on the income statement) and the differences in data aggregation level of the financial performance reporting statement affect the investors' judgments on operating performance evaluation. Thus, the research question is formally stated below:

RQ: Do proposed format financial statements improve the investors' operating performance evaluation judgments when compared to traditional format financial statements?

Specifically, the variation in income statement categorization and the data aggregation levels presented on the face of income statement are explored in this study. Categorization refers to the aforementioned totals and subtotals, namely

Business (Operating and Investing), Discontinued operations, Income taxes, Financing, as opposed to those in traditional income statement. In addition, the proposed format of income statement requires the presentation or disclosure of by-nature information in addition to by-function presentation. Note that by-function information describes the cost associated to primary activities that an entity engages such as manufacturing cost and selling and administrative expenses, whereas by-nature information describes the input costs required to achieve those primary activities such as materials, labor, and transportation.

According to the *Incomplete Revelation Hypothesis (IRH)* proposed by Bloomfield (2002), “*statistics that are more costly to extract from public data are less completely revealed by market prices.*” Presentation format of financial statements and data aggregation level on the face of financial statements can alter and influence the cost to extract financial information relevant to financial statement analysis.

In addition, the literature on *Human Processing Information* provides an explanation on the impact of data aggregation level in financial reporting on investors’ judgments.

The proposed financial statements is hypothesized to improve investors’ operating performance evaluation judgments because they better portray the linkage among the financial statements, segregate the operating activities from other activities, and reveal more details on the nature of input costs associated with major expense categories.

The aforementioned research question is experimentally examined due to two reasons. First, experimental research is best when uses to study individuals’ judgments and decision making (Bonner, 1999). My research question explores how the differences in presentation format and the differences in data aggregation level affect the investor’s judgments when they assess operating performance of a given firm. Second, since the proposed format financial statements have not been adopted at the moment; thus, using empirical archival research methodology is unattainable. The experiment study can provide *ex ante* evidence on new proposed changes in financial statement presentation (Libby et al., 2002).

I use two experiments to examine the impact of the proposed format financial statements on investors’ operating performance evaluation judgments. Experiment 1

provides the empirical evidence on the impact of financial statement presentation formats (working format financial statements as opposed to mixed format financial statements or traditional financial statements) on investors' operating performance evaluation judgments; while Experiment 2 provides the empirical evidence on the impact of data aggregation level (by-nature disaggregation on the statement of comprehensive income or income statement) on investors' operating performance evaluation judgments.

Experiment 1 uses a 3 (*Financial Statement Formats*) X 1 between-subjects design. The Financial Statement Format variable is manipulated in three levels: (1) *Traditional Financial Statements (TFS)*, (2) *Mixed Format Financial Statements (MFS)*, and (3) *Working Format Financial Statements (WFS)*. Experiment 2 uses a 3 (*Data Aggregation Level*) X 1 between-subjects design. The Data Aggregation Level variable is manipulated in three levels: (1) *By-Nature Disaggregation is Disclosed in the Notes Disclosure (NOTES)*, (2) *No By-Nature Disaggregation is Presented or Disclosed (NO)*, and (3) *By-Nature Disaggregation is Presented on the Face of Income Statement (FACE)*. The knowledge variables are used to control prior knowledge that the participants bring to the experiments.

The results from two experiments reveal that the proposed working formats financial statements, as opposed to traditional financial statements, improve ability of the investors to evaluate operating performance of a given firm due to the fact that the operating income is presented in a separate section with prominent label, which is consistent with the Incomplete Revelation Hypothesis. The proposed financial statements are associated with less cognitive cost to extract the operating-related information. The results of this study suggest that presenting by-nature information on the face of financial statements rather than disclosing by-nature information in the notes enhances the investors' ability to pinpoint the problems associated with operations. This implies that presenting a more expanded and more detailed by-nature information on the face of financial statements improve the financial reporting productivity and judgment quality, which is consistent with human information processing literature.

This paper is theoretically important in that it extends prior literature on firm's financial performance evaluation and earnings informativeness. Moreover, this paper

extends the psychology and human information processing literature by providing evidence on its application to accounting context. Besides, the findings of this study would provide evidence supporting the Incomplete Revelation Hypothesis resulting from differential presentation of financial information. Last but not least, this paper has practical contribution to the standard setters by providing *ex ante* empirical evidence on the impact of proposed accounting standard pertaining to financial statement presentation on the financial statement users' judgments when they evaluate the firm performance. That is to say, this paper has a policy-implication. The concerns or unintentional consequences that might result from human cognitive limitations would be voiced and necessary precautions can then be established before implementing the proposed financial statement presentation standards.

Moreover, this paper reveals the latest development on IASB/FASB joint project on financial statement presentation to the interested public. This would provide the opportunity for the financial statement users to learn and comprehend the working format financial statements even before they are implemented. If there are any unintentional consequences resulting from cognitive limitations of the financial statement users, the financial statement users are then aware of those effects and figure the way to preclude them from happening if, at all, possible. This would increase the efficiency and effectiveness in utilizing financial information from working format financial statements for credit and investment decisions.

The remainder of this paper is organized as follows. Chapter 2 discusses the theoretical background and hypothesis development, which encompasses three major parts. The importance of performance reporting is first discussed. The recent development of authoritative guidance related financial statement presentation is then discussed. Finally, the literature reviews on human information processing, sophistication and knowledge of investors and the incomplete revelation hypothesis are then followed. Chapter 3 describes the research methodology, experimental design and procedures, research participants, independent variables and dependent variables. Chapter 4 discusses the research findings and Chapter 5 summarizes and concludes this research paper.