Project **Financial Statement Presentation**

Topic **FASRI Experimental Study**

Purpose of this paper

1. At the September 2009 IASB meeting and the September 21, 2009 FASB meeting, the Director of the Financial Accounting Standards Research Initiative (FASRI), Professor Robert Bloomfield (Cornell University), will discuss the results of a FASRI research study that tested the decision-usefulness of two proposals contained in the October 2008 discussion paper, *Preliminary Views on Financial Statement Presentation.*

2. The attached research study paper (Appendix 1) provides an overview of the FASRI research study (paragraphs S1–S6), it then describes the research methodology (paragraphs M1–M15) and the research results (paragraphs R1–R26). The paper ends with a discussion of implications and caveats (paragraphs D1–D3).

3. Professor Robert Bloomfield will use the attached PowerPoint presentation (Appendix 3) during his discussion with the IASB and the FASB at their September meetings.

Appendix 1

FASRI Experimental Study of Credit Analysts' Judgments

Robert Bloomfield, FASRI Director

Summary

S1. This paper provides background to Board and staff members of the FASB and IASB concerning a research effort by the Financial Accounting Standards Research Initiative (FASRI). This FASRI research study tested the decision-usefulness of specific proposals contained in the October 2008 Discussion Paper, *Preliminary Views on Financial Statement Presentation* (hereafter "FSP"). Sixty experienced credit analysts participated in the experiment, which was conducted by Professor Bloomfield, along with Frank Hodge (University of Washington), Patrick Hopkins (Indiana University) and Kristina Rennekamp (Cornell University).

S2. The experiment focused on two particular proposals contained in FSP:

(a) To **classify** the statement of financial position, statement of comprehensive income and statement of cash flows into operating, investing and other categories; and

(b) To **disaggregate** expense items on the statement of comprehensive income and statement of cash flows by function and nature.

S3. The credit analysts received financial statements of two fictitious apparel manufacturer firms that were very similar, except that one firm had outsourced most of its production duties and was holding its unneeded property, plant and equipment as investment assets for rental and possible future sale. Our experiment altered

(a) Whether the financial statements were classified by activity on their face, or whether classification information was provided in notes to the financial statements; and

(b) Whether the financial statements disaggregated information about expenses and cash flows on their face, or whether disaggregated information was provided in the notes to the financial statements.

These two variations resulted in four different versions of financial statements, as shown below:

		Disaggregation (by Function and Nature)	
		Disaggregated in Notes	**Disaggregated on Face**
Classification (by Activity)	**Classified in Notes**	Not Classified/Not Disaggregated (Version 1)	Not Classified/ Disaggregated (Version 2)
	Classified on Face	Classified/ Not Disaggregated (Version 3)	Classified/ Disaggregated (Version 4)

Experimental Design

S4. Because the footnote disclosures provided to the analysts are more detailed than those required by current standards, our experiment should be interpreted as comparing different possible improvements to existing reporting, rather than comparing proposed to existing reporting. Copies of Version 4 of the financial statements are provided in Appendix 2. Additional financial statements, along with notes and other materials provided to research participants, are available upon request.

S5. The results indicate that:

(a) Financial statements that are classified and disaggregated on their face appear to help analyst forecasts and judgments the most. Analysts receiving this version of the financial statements provided forecasts that reflected the difference in cost structure between the two firms, were likely to identify differences in cost structure, financial flexibility and the presence of a diversified cash inflow when justifying their credit rating decisions, and rated the financial statements as more transparent than what they usually receive.

(b) Analyst performance was also strong when receiving financial statements that are neither classified nor disaggregated on their face, but provide this information in notes to financial statements. However, analysts were less

likely to identify the outsourcers diversified cash inflows, and rated these financial statements as less transparent than the version described above. Financial statements that are classified **and** disaggregated on the face were rated as more transparent than the other statements, and were the only version of statements to be rated as more transparent than the statements the analysts usually receive.

(c) Analyst performance was worst when financial statements were classified on their face, but disaggregated information about the nature and function of expenses was provided in notes. Analyst performance was also relatively poor when information about classification was provided in notes, but expenses were disaggregated by nature and function on the face of the statements.

S6. Overall, our results indicate that there are benefits to organizing financial statements so that information conveyed by classification and disaggregation is presented in one location. Providing such information entirely on the face of the financial statements leads analysts to rate the financial statements as more transparent than presenting such information entirely within the notes, but performance in both cases is better than when such information is spread between the face of the financial statements and the notes.

Method

General approach

M1. The FASRI Experiment Team met numerous times with the Financial Statement Presentation Project Team, along with Tom Linsmeier and FASB Research Fellows Robert Lipe and Ray Pfeiffer, to design an experiment that would be helpful in the boards' deliberations on the discussion paper. The research study incorporates feedback on various draft research proposals received from all FASB Board members, several IASB Board members, and members of the FASB's Investors Technical Advisory Committee. We collected data from the credit analysts on several trips to New York City in early 2009.

M2. While FSP proposes many changes to current financial statement presentation, an experimental study must focus its attention on a small set of questions. We

focused on two key features proposed by FSP that seemed likely to be a topic of deliberations in 2009 and 2010:

(a) **Cohesive Classification by Activity:** FSP proposes that firms classify assets and liabilities into those associated with operating, investing and financing activities, and maintains those classifications cohesively across financial statements (so that, for example, an investing asset generates investing cash flows, income and expenses).

(b) **Disaggregation of Expenses by Function and Nature:** FSP proposes that the Statement of Comprehensive Income and the Statement of Cash Flows **separately** list income and expense items that differ by function or nature. As FSP defines these terms, *Function* refers to the primary activities in which an entity is engaged, such as, manufacturing, advertising, marketing, business development, selling or administration (Para 3.43). *Nature* refers to the economic characteristics or attributes that distinguish assets, liabilities, and income and expense items that do not respond equally to similar economic events.

M3. The boards received over 220 comment letters, many of which weighed in on the value of these two features (which we simply call *classification* and *disaggregation*). The project team also compiled results from a field test in which firms were asked to prepare financial statements in accordance with FSP, and analysts were presented with FSP-compliant financial statements. Our experimental research complements the comment letters and the field test by examining the quality of specific decisions (and the reasons supporting those decisions) given specific sets of financial statements. In contrast, comment letters and field test responses reflect respondents' speculations of how financial statements prepared in accordance with FSP might look, and how such statements might aid hypothetical decisions.

The decision: assessment of credit risk

M4. One desired effect of classification and disaggregation is to help users of financial statements assess a firm's creditworthiness. We test the effectiveness of classification and disaggregation by asking experienced credit analysts to

provide forecasts and credit ratings for two firms in the same industry that differ primarily in their production strategies. To this end, we created financial statements for two fictitious apparel manufacturers. One firm (Apex) has outsourced much of their production, while the other (Zen) produces their goods in-house. The two firms have similar fixed assets, because the outsourcer holds its property, plant and equipment no longer used for production as investment assets for rental to others. To keep the firms from looking too similar, the insourcers' assets were made to be about 4% smaller than the outsourcers' assets, with all other numbers scaled to match.

M5. The experimental task took about 75-90 minutes. Analysts began by examining financial reports for both firms, which included a complete set of financial statements and a business summary. Participants also learned that the industry was suffering a downturn in demand and a decline in orders from a major customer. We asked participants to make a number of financial projections and assessments, determine which of the two firms was more deserving of a credit rating downgrade, and defend their decision. Finally, participants answered a number of questions about the financial statements and provided some demographic information.

M6. Given complete information, credit analysts should have viewed the outsourcer (Apex) as being more creditworthy, because their costs include a smaller fixed component and a larger variable component than the insourcer. Classified and disaggregated financial statements allow analysts a clear look at the firms' cost structures. Beginning with the statement of financial position, both firms have roughly the same amount of property, plant and equipment. However, a classified statement of financial position shows that Zen (the insourcer) has all $310,644 of its property, plant and equipment classified as operating, while Apex (the outsourcer), has only $32,307 classified as operating, with its remaining $290,763 classified as investing. Thus, a quick look at the statements of financial position, shown in Figure 1 below, reveals that only Apex has substantial fixed assets that could be disposed of without impinging on operations.

STATEMENTS OF FINANCIAL POSITION
As of December 31, 2007

	Apex (Outsourcer) 2007	Zen (Insourcer) 2007
BUSINESS	(amounts in thousands)	(amounts in thousands)
Operating		
Accounts receivable (net of allowance)	$ 195,615	$ 188,091
Inventory, net	210,009	201,932
Prepaid expenses	43,235	41,572
Total short-term assets	**448,859**	**431,595**
Property plant and equipment (net of accumulated depreciation)	32,307	310,644
. . .		
Investing		
Money market and mutual funds	22,566	21,698
Property plant and equipment (net of accumulated depreciation)	290,763	N/A
Total investing assets	**313,329**	**21,698**
. . .		

Figure 1. Excerpt from Version 4 Statement of Financial Position.

M7. Because FSP emphasizes cohesive classification, the statements of comprehensive income reflect depreciation expense with the same classifications as the statements of financial position: depreciation on property, plant and equipment is split between operating and investing for Apex, the outsourcer, but is entirely within operating expenses for Zen, the insourcer. In accordance with FSP, the classification of property, plant and equipment results in cohesive classification on the statements of comprehensive income, so that the depreciation of Zen's property, plant and equipment is classified entirely within operations, while Apex's depreciation is split between the operating and investing sections.

M8. The disaggregated statements of comprehensive income, shown below, further clarify the differences between the two firms. Both firms have cost of goods sold that is 53% of sales in 2006. However, Apex, the outsourcer, has the bulk of its costs in the form of materials (46% of sales), while Zen, the insourcer, has the bulk of its costs in the form of labor, overhead, freight, transportation and handling (37% of sales). Both firms experience a sales decline of 8.4%. However, Apex's reliance of variable materials costs leads its costs of goods sold to decline by 7.6%, while Zen's reliance on largely fixed production costs leads its costs of goods sold to decline by only 4.8%.

STATEMENTS OF COMPREHENSIVE INCOME
For the years ended December 31, 2007 and 2006

	Apex (Outsourcer)		Zen (Insourcer)	
	2007	2006	2007	2006
BUSINESS	(amounts in thousands)		(amounts in thousands)	
Operating				
Sales	$ 1,538,726	$ 1,679,233	$ 1,479,545	$ 1,614,648
Cost of goods sold				
Materials	711,615	779,017	261,369	285,235
Freight and transportation	20,837	21,212	103,395	105,199
Labor	42,794	44,731	209,892	219,204
Depreciation	3,260	3,557	31,342	34,204
Handling	10,208	11,236	66,484	70,660
Other overhead	27,563	28,060	136,771	139,158
Decrease in fair value of cash flow hedges	3,770	-	3,625	-

Figure 2. Excerpt from Version 4 Statement of Comprehensive Income.

M9. The difference in the cost structure of the firm is revealed in summary fashion by the expense variability ratio (EVR):

EVR = Percentage Change in Expenses/Percentage Change in Sales

A firm with only fixed expenses and no variable expenses would have an EVR of 0, while a firm with only variable expenses and no fixed expenses would have an EVR of 1. Apex, the outsourcer, has an EVR of 0.86, which indicates far more variable expenses than Zen, which has an EVR of 0.58. (The total expense numbers used to derive these estimates are provided in Appendix 2.)

Experimental design to test for decision-usefulness of proposed presentation

M10. The goal of our experiment is to test whether the proposed classification and disaggregation on the face of financial statements facilitate better credit rating decisions, either separately or in combination. We do so by creating four versions of the financial statements for each firm, as shown in Figure 3 below.

		Disaggregation (by Function and Nature)	
		Disaggregated in Notes	**Disaggregated on Face**
Classification (by Activity)	**Classified in Notes**	Not Classified/Not Disaggregated (Version 1)	Not Classified/ Disaggregated (Version 2)
	Classified on Face	Classified/ Not Disaggregated (Version 3)	Classified/ Disaggregated (Version 4)

Figure 3. Experimental Design.

M11. For the "Classified on Face" versions, firms classify all assets and liabilities into operating, investing and financing activities, and carry that classification cohesively to the statement of cash flows and statement of comprehensive income as proposed in FSP. For the "Classified in Notes" versions, firms classify items into operating, investing and financing activities only on the statement of cash flows according to existing literature, but provide a footnote disclosure that indicates the amount of property, plant and equipment held for investment, rather than operations. In the "Disaggregated on Face" versions, the firms provide detail on the nature and function of expenses in the statement of comprehensive income and the statement of cash flows. For the "Disaggregated in Notes" versions, equivalent information is provided in footnote disclosures.

M12. Classification on the face of the financial statements reveals the ability of Apex, the outsourcer, to shed significant non-operating investment in property, plant and equipment; however, the lack of disaggregation on the statement of comprehensive income and statement of cash flows makes it very difficult to assess the variable nature of the outsourcer's cost of goods sold expenses. Disaggregation on the face of the financial statements without classification does not easily clarify the investment assets held by the outsourcer, but does very clearly illuminate the firms' differing cost structures.

Theory and controls

M13. Academic research suggests that changes to presentation can alter the decision-usefulness of financial reports for three reasons:

(a) **Inference Effects.** Changes to presentation can alter the expected relevance and reliability of particular financial statement items. Investors can use the Conceptual Framework to infer that recognized items are more likely to be relevant and reliable than information that standard-setters have chosen not to recognize, but merely disclose. Experimental research indicates that such inferences are reasonable, and that auditors are more cautious about attesting to recognized items than footnote disclosures. Even decisions to mandate or allow certain subtotals to be emphasized can be viewed as endorsing their importance.

(b) **Interpretation Effects.** Changes to presentation can alter interpretations of financial statement items because users have limited processing power and financial sophistication. For example, presentation can make information easier to find. Several studies have shown that users devote little time to the statement of changes in equity. Thus, reporting gains and losses only in that statement can reduce the likelihood that users extract that information, or reduce the weight they place on it. Providing large quantities of information without providing context or indications of relevance can create "information overload" that confuses investors or distracts them from more relevant information.

(c) **Information Effects.** Changes to presentation can alter the information that a purely rational user can extract from the financial reports given unlimited processing ability and financial sophistication, assuming that presentation does not alter the likely reliability or relevance of statements. Examples of information effects could include, for example, providing information that simply was unavailable in the statements before (such as expenses disaggregated by function and nature).

M14. Whether classification and disaggregation are provided on the face of the financial statements or in the notes to the financial statements can potentially alter users' decisions for all three reasons described above. In the absence of

footnote disclosures, both classification and disaggregation can have information effects in our experimental task. Classification reveals that the outsourcer has less property, plant and equipment devoted to operations and more devoted to investment. Disaggregation reveals that the outsourcer has fewer fixed costs and more variable costs in cost of goods sold.

M15. To isolate the inference and interpretation effects of presentation from the information effects, when classification and/or disaggregation is not provided on the face of the financials statements we provide investors with an extensive set of footnotes that break down assets into operating and investing assets, and disaggregate expenses and cash flows by function and nature. Providing such footnotes has several advantages:

(a) We have no doubt that the information effects of classification and disaggregation would improve decisions. More open to question is whether classification and disaggregation facilitate decision-making via inference and interpretation effects. It is entirely possible that disaggregation would hinder decision-making by providing too much information (information overload), especially if the information is not viewed as useful, and makes it harder for analysts to extract more useful information. Similarly, classification could hinder decision-making if the categories are not defined in a useful manner, and therefore confuse users, rather than inform them.

(b) Providing information in footnotes when it is not available in the primary financial statements makes it less likely that we will observe differences across versions. As a result, any beneficial effects of classification and disaggregation on the face of the financial statements that we observe would likely be amplified without such footnotes, because users would lack information about the firms' cost structures.

(c) Some comment letters indicate that footnote disclosures would be preferable to classification and disaggregation on the face of the financial statements. For example, paragraph 44 of the July 2009 staff-prepared comment letter summary states the following with regard to disaggregation by function, nature or both:

> However, many respondents are concerned that disaggregation to such a detailed level would place too much information on the statement of comprehensive income. Those respondents think that the level of disaggregation proposed in the discussion paper may make the financial statements less understandable and could overwhelm users of the financial statements with information.

Our experiment directly addresses how this difference in presentation would affect the decision-usefulness of financial statements.

Results

R1. We asked analysts for four types of responses (in addition to demographic data):

(a) Projections of future financial performance for the two firms

(b) A decision on which firm to downgrade

(c) Explanations for why they made the decisions they did

(d) Assessments of the qualities of the financial statements we provided.

We discuss each of these four categories of responses below, along with our interpretations.

R2. We conducted several types of statistical tests to determine whether the effects of classification and disaggregation are simply due to chance. (For example, if analysts were simply providing random responses, we would have a 50% chance of showing that classification improved perceptions of transparency.) We assessed the statistical reliability of our comparisons by calculating a "p-value," which reflects the probability that we would have observed an average difference at least that big if analysts were simply behaving randomly, with their decisions unaffected by financial statement presentation.

R3. In cases where an observed difference is **consistent** with our directional prediction, we consider a p-value to be reliable evidence that analysts are affected by financial statement presentation if there is less than a 10% chance that random responses would generate the observed difference or larger. (This is referred to as a "1-tailed" test.)

R4. In cases where an observed difference is **inconsistent** with our directional prediction, we consider a p-value to be reliable evidence that analysts are affected by financial statement presentation if there is less than a 5% chance that

random responses would generate the observed difference or larger in either direction. (This is referred to as a "2-tailed" test.)

R5. To reduce the risk that readers of this paper will inappropriately rely on a difference that is not statistically reliable, the text of this report describes differences in behavior across versions of financial statements, or differences of measured variables from 0, only if those differences are statistically reliable evidence as indicated by p-values.

Projections and expense variability ratios

R6. We begin our analysis with the most direct measure of analysts' understanding of the firm's cost structure: their estimates of how expenses will change in response to the expected decline in revenue. Each analyst was asked to project both *revenue* and *earnings before interest and taxes* (EBIT) for each firm. We use their responses to calculate a projected *expense variability ratio* (EVR) for each firm, where *EVR = Percentage Change in Expenses/Percentage Change in Sales* (see also paragraph M9). We compute the EVR for both the outsourcer and insourcer, and then compute the difference (outsourcer minus insourcer) for each analyst. The median of each variable, as well as differences across versions, are shown in Table 1, below.

		Disaggregated in Notes	Disaggregated on Face		Row Medians
Classified in Notes	**$EVR_{outsourcer}$**	79.8%	90.4%		83.5%
	$EVR_{insourcer}$	63.4%	73.8%		67.6%
	$EVR_{outsourcer-insourcer}$	**14.7%**	**13.5%**		**13.9%**
Classified on Face	**$EVR_{outsourcer}$**	86.9%	80.0%		85.2%
	$EVR_{insourcer}$	88.9%	80.3%		80.8%
	$EVR_{outsourcer-insourcer}$	**4.3%**	**9.3%**		**5.2%**
Column Medians	**$EVR_{outsourcer}$**	79.9%	85.8%		83.9%
	$EVR_{insourcer}$	75.0%	78.0%		76.2%
	$EVR_{outsourcer-insourcer}$	**5.2%**	**13.1%**		**6.5%**

Table 1. Expense Variability Ratio (EVR) Medians. The EVR is calculated as the percentage change in Expenses divided by the percentage change in Sales. Higher numbers indicate costs that are more variable and less fixed. Numbers referred to for key comparisons are shown in bold. Note that the difference between two medians is not the same as the median of the difference.

R7. Overall, we find that analysts in all versions assess a higher EVR for the outsourcer than the insourcer, with a median difference of 6.5%. This difference is significantly greater than 0, suggesting that overall, analysts were indeed able to assess the difference in cost structures between the two firms.

R8. Disaggregation increases the difference in EVR for the two firms (13.1% is greater than 5.2%). Counter to our prediction, however, classification actually *reduces* the difference in the EVR (5.2% is less than 13.9%), suggesting that classification actually makes it more difficult for analysts to understand the differences in cost structures for the two firms.

R9. Version-to-version comparisons show that disaggregation increases the difference in EVR only when the statements are classified (9.3% is greater than 4.3%), but not when they are not classified (13.5% is not reliably different from 14.7%). The simple (harmful) effect of classification is significant only when there is no disaggregation (4.3% is less than 14.7%). When disaggregation is provided, we find no significant effect (9.3% is not reliably different from

13.5%). There is no difference between the version in which both disaggregation and classification are provided on the face of the financial statements and the version in which both are provided in the notes. All four versions are shown in Figure 4, below.

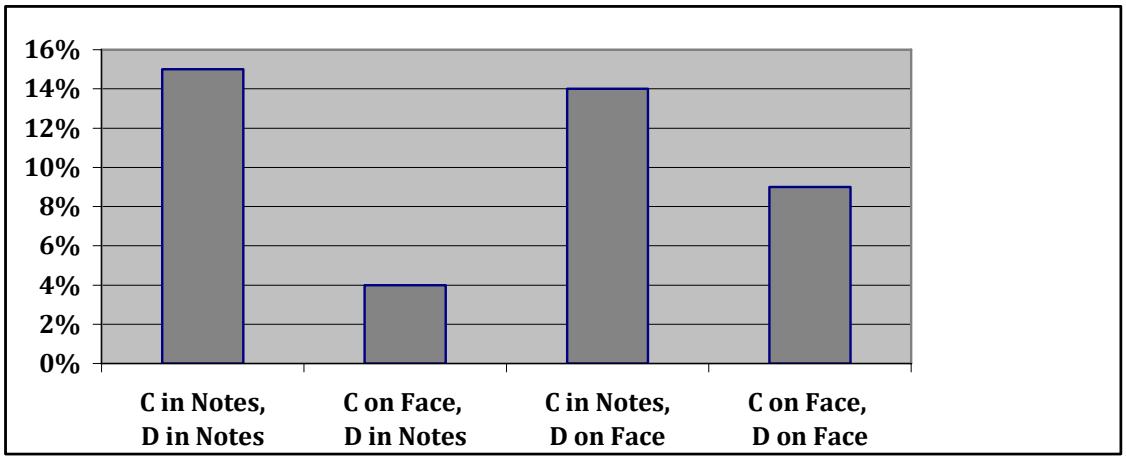

Figure 4. Outsourcer EVR – Insourcer EVR by Experimental Condition.

R10. Overall, our analysis of expense variability ratios suggests that disaggregation in the primary financial statements is helpful in allowing analysts to understand the firms' cost structures, particularly when combined with classification in the notes, but that classification makes it harder for analysts to do so, particularly when disaggregation is in the notes rather than on the face of the financial statements.

R11. An alternative interpretation of the results is that analysts estimate too large an estimated difference in EVR across the firms when they receive classified and disaggregated financial statements, and that the smaller differences observed in other versions are more appropriate. This seems unlikely for two reasons. First, using the decline in sales and expenses reported in the 2006 and 2007 financial statements, the EVR is 0.86 for the insourcer and 0.58 for the outsourcer, for a difference of 0.28. This difference is substantially larger than estimated by analysts. Second, the difference in EVR is reliably greater than 0 only in the version with both disaggregation and classification on the face of the financial statements. Given the clear difference in cost structures between the insourcer

and outsourcer, we do not believe that analysts estimated too large of an EVR difference for any version of the financial statements.

Downgrade decisions

R12. After making their judgments, we asked analysts the following question:

> Assume that your firm's debt-rating algorithm mechanically assigned identical ratings to both Apex Apparel and Zen Apparel prior to release of the information about XYZ Retail Group, Inc. Please pick **one** of the companies to downgrade, and indicate if you would downgrade the company one or two notches. Please place an "X" in **only one** of the following boxes:
>
> ☐ Downgrade **Apex** to 2 notches below mechanical rating
> ☐ Downgrade **Apex** to 1 notch below mechanical rating
> ☐ Downgrade **Zen** to 1 notch below mechanical rating
> ☐ Downgrade **Zen** to 2 notches below mechanical rating

R13. Our results for the downgrade variable show a strong consensus that the insourcer should be downgraded, rather than the outsourcer (46 vs. 10), confirming our interpretation from the overall EVR difference that analysts are able to understand the difference in cost structure between the firms. (One participant indicated that both should be downgraded, while another indicated that neither should be downgraded.) However, we see little evidence that the placement of classified or disaggregated information affected downgrade decisions. Given the effects of these treatments on other variables, it is most likely that our method of eliciting downgrade decisions was simply too coarse to detect an effect. (A more precise elicitation might have been to ask analysts to rank, on a 100-point scale, how strongly they would advocate downgrading the firm.)

Reasoning behind downgrade decisions

R14. To clarify the ability of classified and disaggregated financial statements to facilitate analysts' judgments, we asked participants to "Please provide the three key pieces of information that determined the firm you selected for your rating-change recommendation." We created three categories to reflect the key

differences between the insourcer and the outsourcer as follows (also see the shaded rows in Table 2):

(a) The outsourcer has a more favorable *cost structure* during bad times (more variable costs and fewer fixed costs)

(b) The outsourcer has greater *asset disposition flexibility* (because they can sell off their investment assets without harming operations)

(c) The outsourcer has more *diversification* in their sources of cash flows (because rent from the investment property is likely to be only weakly correlated with apparel market conditions).

R15. We created three additional categories (not shaded in Table 2) to capture the other reasons for downgrade decisions that were mentioned frequently by analysts. Research assistants, who knew nothing about the purpose of the study or the version each analyst saw, used the descriptions in Table 2 to assign analysts' responses to the appropriate categories.

Justification	Description
Cost Structure Flexibility	Any reference to 'cost structure' or synonyms; the fact that the Insourcer will be less able to shed costs; the fact that the Outsourcer will be able to shed costs in light of a decline. These need not be comparative.
Cost Reduction Flexibility	Any indication that the Insourcer, because it has high operating or production or overhead costs, will be able to reduce those costs, counts in this category.
Diversification	Any indication that the Outsourcer has rent income which may differ from retail income (or the words diversify or balance) counts in this category.
Capital Structure Flexibility	Any reference to the Insourcer's ability to sell off assets counts in this category.
Superior Strategy	Any indication that the Outsourcer has a flawed strategy because it is holding investment properties, is outsourcing production, or that the Insourcer has a good strategy because it is making its own goods and does not hold investment properties, counts in this category.
Past Performance	Any comment that margins, EBIT, cash flows, or other performance metrics are worse for the Insourcer counts in this category.

Table 2. Descriptions of Downgrade Justification Decisions.

R16. Table 3 below indicates the percentage of analysts that used each of the six categories in Table 2 to justify their downgrade decisions:

	Justification	Disaggregated in Notes	Disaggregated on Face
Classified in Notes	Cost Structure Flexibility	50%	20%
	Cost Reduction Flexibility	29%	13%
	Diversification	0%	13%
	Capital Structure Flexibility	7%	0%
	Superior Strategy	0%	13%
	Past Performance	86%	80%
	Justification	**Disaggregated in Notes**	**Disaggregated on Face**
Classified on Face	Cost Structure Flexibility	24%	50%
	Cost Reduction Flexibility	6%	36%
	Diversification	18%	29%
	Capital Structure Flexibility	0%	14%
	Superior Strategy	0%	7%
	Past Performance	100%	71%

Table 3. Justifications Given for Downgrade Decisions. Percent of analysts in each version mentioning the indicated items in response to the question "Please provide the three key pieces of information that determined the firm you selected for your rating-change recommendation."

R17. The results indicate that classification and disaggregation on the face of the financial statements strongly affect the likelihood that analysts identify cost structure as a key reason to downgrade the insourcer, rather than the outsourcer. Figure 5, below, reports the percentage of analysts referring to 'cost structure' or synonyms (including discussions of fixed and variable costs), the fact that Zen will be less able to shed costs, or the fact that Apex will be able to shed costs in light of a decline. The data, graphed in Figure 5, indicate a strong positive interaction between classification and disaggregation. When participants are provided with either classification and disaggregation in the notes to the financial statements or are provided with both classification and disaggregation on the face of the financial statements, significantly more (14 of 28) mention *cost structure flexibility* as a key piece of information than when financial statements were classified on their face, but disaggregated information about the nature and function of expenses was provided in notes or when information

about classification was provided in notes, but expenses were disaggregated by nature and function on the face of the statements (7 of 32).

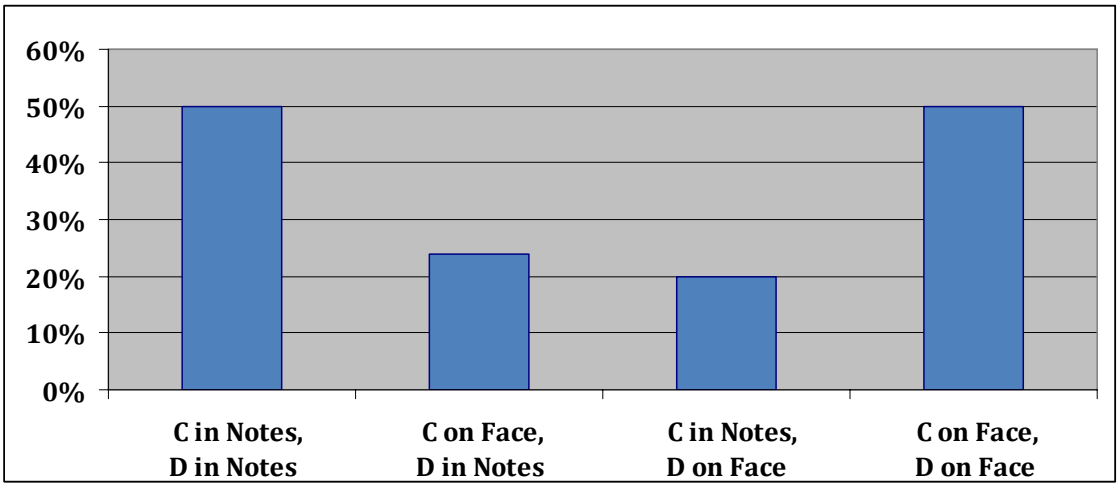

Figure 5. Cost Structure Flexibility Assessments by Experimental Condition. Percent of analysts in each version mentioning "cost structure" in response to the question "Please provide the three key pieces of information that determined the firm you selected for your rating-change recommendation."

R18. We find similar results when examining the percentage of analysts referring to the outsourcer's flexibility in disposing of their investment. When provided with both classification and disaggregation on either the face of the financial statements or in the notes, 9 of 28 note the ability to reduce costs; when provided with information that places one factor in the notes and one in the financial statements, only 3 of 29 mention it.

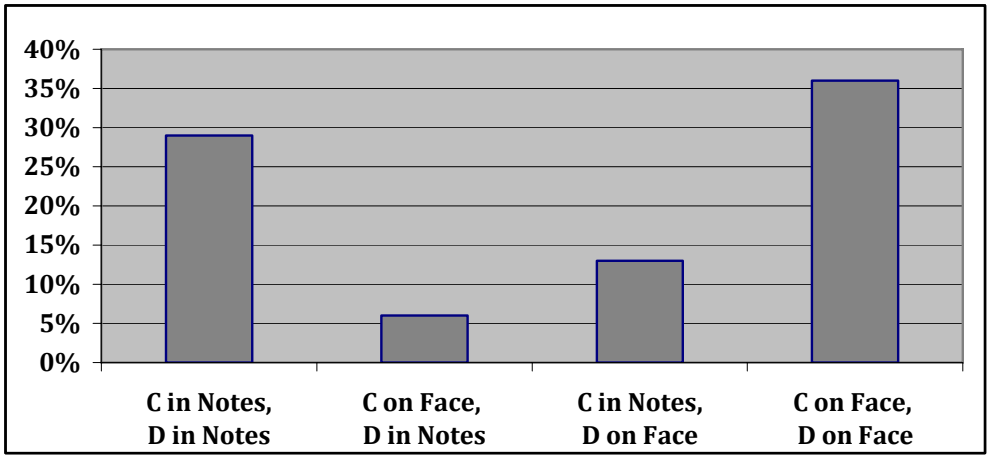

Figure 6. Asset Disposition Flexibility Assessments by Experimental Condition. Percent of analysts in each version mentioning "asset disposition flexibility" in response to the question "Please provide the three key pieces of

information that determined the firm you selected for your rating-change recommendation."

R19. The preceding two analyses suggest that it is important for the information conveyed by classification and disaggregation to be presented together in the financial statements. When the primary financial statements were both classified and disaggregated, analysts could find all of the key information about cost structure and asset disposition flexibility in the primary financial statements. When the primary financial statements were neither classified nor disaggregated, analysts could find **all** of this information in the notes to financial statements. When the primary financial statements were classified but not disaggregated, or disaggregated but not classified, analysts were forced to extract the relevant information from both the primary financial statements and the notes—a task that appears to be considerably more difficult.

R20. Analysts are significantly more likely to identify the outsourcers' diversified cash flow stream when financial statements are classified. When financial statements are classified, 7 of 31 refer to this *diversification* advantage of the outsourcer; when statements are not classified, only 2 of 29 do so. (Disaggregation on the face of the financial statements does not reliably increase the proportion of analysts mentioning diversification as a justification for their downgrade decision.)

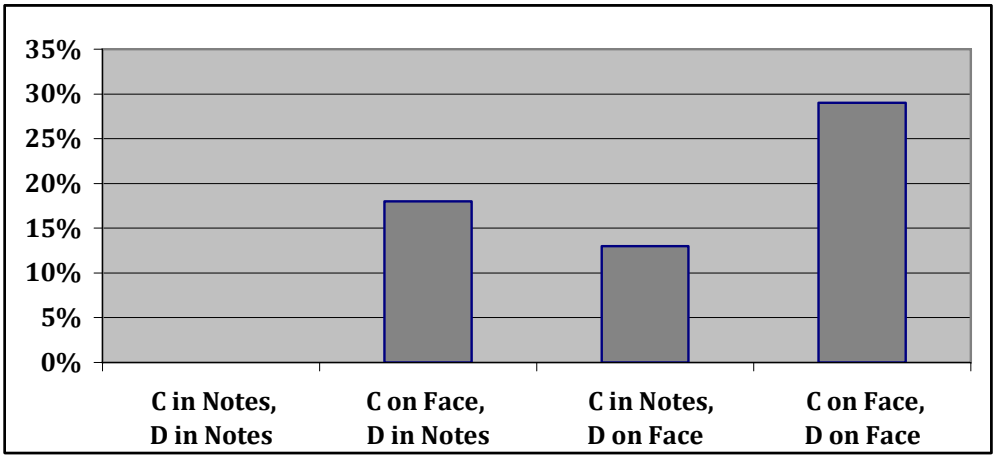

Figure 7. Diversification Assessments by Experimental Condition. Percent of analysts in each version mentioning "diversification" in response to the question "Please provide the three key pieces of information that determined the firm you selected for your rating-change recommendation."

Analysts' views on financial statement presentation

R21. Our last set of dependent variables assesses analysts' own views on the quality of the financial statements they received in the experiment. Our first evidence on this matter comes from answers to the following question: "Compared to the financial statement information I typically review, I found the financial statement information reported by Apex to be transparent," with a response on a 15-point scale ranging from *strongly disagree* to *strongly agree*, which we report below on a scale ranging from -7.5 for *strongly disagree* to +7.5 for *strongly agree*.

R22. The mean responses on financial statement transparency are shown below. Only responses by analysts who received both classified **and** disaggregated information on the face of the financial statements reported greater transparency than they typically saw; the difference of that version from the other three is statistically significant. The results therefore affirm the interactive effect of classification and disaggregation: both are required on the face of the financial statements to significantly improve perceptions of transparency.

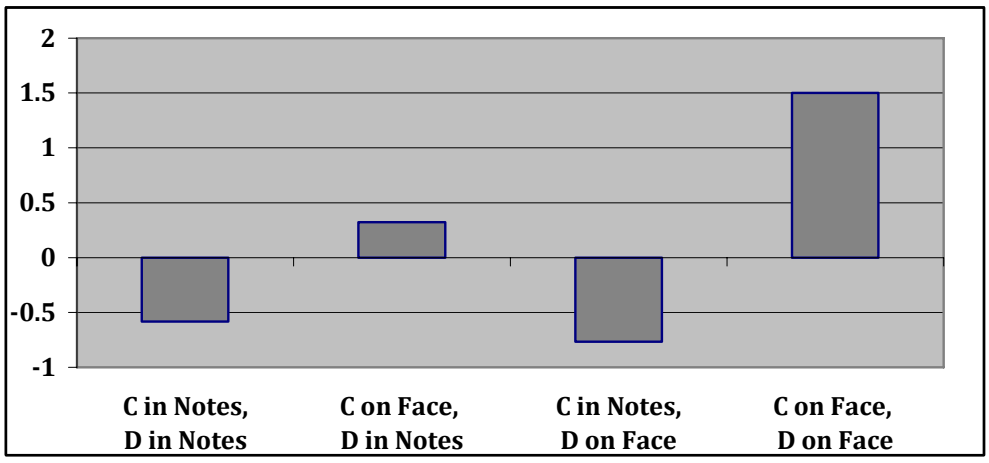

Figure 8. Transparency Assessments by Experimental Condition. Responses to the question "Compared to the financial statement information I typically review, I found the financial statement information reported by Apex to be transparent," with a response ranging from -7.5 (*strongly disagree*) to 7.5 (*strongly agree*).

R23. Additional open-ended questions suggest that disaggregation in the primary financial statements complements classification. We asked analysts what aspects of the financial statements facilitated and impeded analysis. We found

that classification on the face of the financial statements made analysts more likely to cite limited detail in the financial statement as impeding analysis. As indicated in the figure below, only 5 of 29 analysts cited limited detail in financial statements as impeding analysis when classification was provided in the notes; 10 of 31 did so when classification was on the face of the financial statements. This effect again confirms the interactive and synergistic effect of placing classified and disaggregated information in the same location.

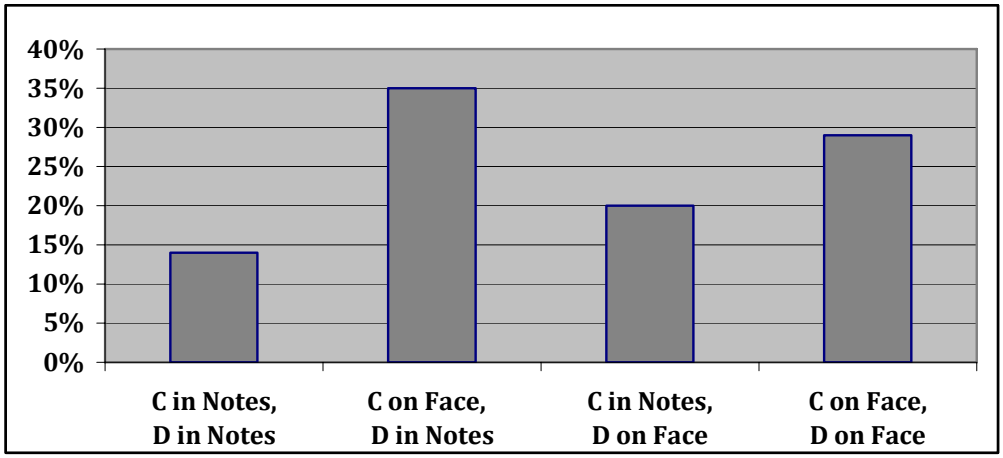

Figure 9. "Limited Detail" Assessments by Experimental Condition. Percentage of participants in each version indicating that a lack of detail in financial statements hindered their analysis.

R24. In a similar manner, analysts who received classified statements were more likely to express a desire to ask management for more information about cash flows (only 1 of 30 with disaggregation in the notes, compared to 6 of 29 with disaggregation on the face of the statements). This result suggests that disaggregation on the face of the financial statements creates demand for more detail, much as classification on the face of the financial statements creates a demand for more detail.

Supplementary analyses

R25. We collected data from 14 additional participants who saw financial statements identical to those in the version with disaggregation and classification in the notes to the financial statements, but with more limited supplementary footnote disclosures. For those participants, footnotes indicated the amount of property,

plant and equipment held for investment, and the breakdown of inventories, but did not provide disaggregated expense information. We found few differences between these two versions, suggesting that participants were able to identify the differences between the firms with the limited information provided. However, the analysts perceived these limited footnotes as being less transparent than the classified and disaggregated statements, and were more likely to demand additional information about cost structure and cash flows than those who received the classified and disaggregated information in the notes, and were also less confident in their assessments of the firms' cost structure. Thus, it appears that these statements allowed analysts enough information to draw reasonable conclusions, but that the lack of detail dampened their confidence in those conclusions.

R26. Although we assigned the 60 credit analyst participants to versions randomly, we found that those assigned to receive disaggregated information on the face of the financial statements (disaggregated statements) had on average only about 5.5 years of experience, compared to an average of about 11.5 years of experience among those who were assigned to receive the disaggregated information in the notes to the financial statements. However, we find that among those receiving disaggregated statements, greater experience actually improves their judgments (as measured by an increase in the EVR assigned to the outsourcer relative to the insourcer). As a result, the lesser experience of those receiving disaggregated statements would lead our results to understate the beneficial effects of disaggregation we would have observed if experience had been similar across all versions.

Discussion

Implications

D1. We presented 60 analysts with financial statements substantially more complex than usually used in academic research. We altered (a) whether the primary financial statements were cohesively classified by activity, or such information was provided in the notes, and (b) whether the primary financial statements

included expense items disaggregated by nature and function, or such information was provided in the notes.

D2. Overall, our results indicate that experienced credit analysts find financial statements more useful, and are better able to identify differences in cost structure across firms, when primary financial statements are classified by activity **and** expenses are disaggregated by nature and function. Many (but not all) of the advantages of both classifying and disaggregating information on the face of the financial statements can be achieved with extensive footnote disclosure. The least preferable form of presentation is to classify financial statements by activity on their face while presenting disaggregated information in footnotes.

Caveats

D3. Like any research study, our results are subject to a number of caveats. Two are particularly important to keep in mind:

(a) We designed our task to examine judgments that were likely to be improved by classification and disaggregation. Our results indicate that classification and disaggregation on the face of the financial statements, in combination, facilitate decision-making in a setting expressly designed to make such facilitation likely. Many decisions will not be facilitated by classification or disaggregation because implementing those presentation features would not convey information relevant to the particular decision at hand.

(b) The analysts participating in our experiment were unfamiliar with the classified format of financial statements; we cannot assess the extent to which our results might differ as analysts gain experience with this new format.

Appendix 2: Version 4 of Financial Statements

Financial Statements – Version 4 (Classified on Face/Disaggregated on Face)

Apex Apparel
STATEMENT OF FINANCIAL POSITION
As of December 31, 2007 and 2006

	2007	2006
BUSINESS	(amounts in thousands)	
Operating		
Accounts receivable (net of allowance of 15,352 and 12,993, respectively)	$ 195,615	$ 212,177
Inventory, net	210,009	194,236
Prepaid expenses	43,235	43,998
Total short-term assets	**448,859**	**450,410**
Property plant and equipment (net of accumulated depreciation of 18,338 and 17,396, respectively)	32,307	32,802
Goodwill	46,634	41,306
Intangible assets, net	56,557	49,780
Leased asset	13,100	11,264
Total long-term assets	**148,598**	**135,152**
Accounts payable	(89,545)	(114,432)
Accrued payroll	(30,942)	(40,015)
Accrued consulting expenses	(33,732)	(37,544)
Accrued freight	(14,548)	(18,740)
Accrued rent	(10,048)	(7,987)
Accrued other	(23,989)	(23,357)
Derivative liabilities	(3,969)	(3,042)
Total short-term liabilities	**(206,773)**	**(245,118)**
Deferred compensation liability	(9,474)	(7,344)
Other long-term liabilities	(4,900)	(1,042)
Total long-term liabilities	**(14,375)**	**(8,387)**
Net operating assets	**376,309**	**332,058**
Investing		
Money market and mutual funds	22,566	22,059
Property plant and equipment (net of accumulated depreciation of 165,039 and 156,568, respectively)	290,763	295,218
Total investing assets	**313,329**	**317,278**
Net business assets	**689,638**	**649,335**
FINANCING		
Cash	273,951	242,672
Total short-term financing assets	**273,951**	**242,672**
Vendor notes payable	(5,200)	(5,200)
Debt	(124,800)	(124,800)
Total long-term financing liabilities	**(130,000)**	**(130,000)**
Net financing assets	**143,951**	**112,672**
INCOME TAXES		
Short-term		
Prepaid income taxes	18,055	12,847
Deferred tax asset	25,924	22,498
Income taxes payable	(19,984)	(51,936)
Accrued interest - uncertain tax position	(3,413)	-
Long-term		
Deferred tax asset	20,229	19,295
Other liabilities - uncertain tax position	(19,808)	-
Net income tax asset (liability)	**21,004**	**2,705**
Net assets	**$ 854,593**	**$ 764,713**
EQUITY		
Common stock and additional paid-in capital	(421,872)	(415,034)
Treasury stock	557,712	538,264
Retained earnings	(975,763)	(872,000)
Accumulated other comprehensive income	(14,670)	(15,943)
Total equity	**$ (854,593)**	**$ (764,713)**

**The accompanying notes are an integral part of these financial statements.*

Financial Statements – Version 4 (Classified on Face/Disaggregated on Face)

Apex Apparel
STATEMENT OF COMPREHENSIVE INCOME
For the years ended December 31, 2007, 2006 and 2005

	2007	2006	2005
BUSINESS	(amounts in thousands)		
Operating			
Sales	$ 1,538,726	$ 1,679,233	$ 1,628,308
Cost of goods sold			
Materials	711,615	779,017	738,275
Freight and transportation	20,837	21,212	20,462
Labor	42,794	44,731	42,747
Depreciation	3,260	3,557	3,349
Handling	10,208	11,236	13,802
Other overhead	27,563	28,060	27,068
Decrease in fair value of cash flow hedges	3,770	-	-
Total cost of goods sold	820,047	887,812	845,703
Gross Profit on Sales	**718,679**	**791,421**	**782,605**
Selling expenses			
Advertising and marketing	153,663	157,125	151,330
Warehousing	38,800	39,499	38,102
Store improvements	12,854	12,854	12,480
Sales force compensation	148,780	159,610	151,150
Other	74,519	79,257	75,282
Total selling expenses	428,616	448,346	428,344
General and administrative expenses			
Compensation	15,653	17,274	15,818
Rent	43,159	41,836	33,781
Depreciation	16,280	14,501	12,728
Other	20,975	34,934	30,059
Total general and administrative expenses	96,067	108,545	92,386
Other operating expenses			
(Gains) losses on futures contracts	(520)	8,736	(3,224)
Other expenses, net	1,926	(1,408)	561
Total other operating	1,406	7,328	(2,663)
Pretax operating income	**192,591**	**227,203**	**264,538**
Investing			
Realized gain on money market and mutual funds	1,106	1,127	1,030
Rental income	21,080	24,127	22,364
Depreciation on investment property	(29,336)	(32,015)	(30,140)
Total investing income/(expenses), net	(7,151)	(6,761)	(6,747)
Total business income	**185,440**	**220,442**	**257,791**
FINANCING			
Interest income	8,831	8,977	9,992
Interest expense	(7,962)	(7,971)	(6,524)
Net income before taxes	**186,308**	**221,447**	**261,260**
INCOME TAX EXPENSE	41,315	58,692	90,242
Net income	**144,993**	**162,755**	**171,018**
OTHER COMPREHENSIVE INCOME			
Foreign currency translation adjustment (operating)	1,457	2,471	(1,511)
Total other comprehensive income	**1,457**	**2,471**	**(1,511)**
Total comprehensive income	**$ 146,450**	**$ 165,226**	**$ 169,507**

**The accompanying notes are an integral part of these financial statements.*

Financial Statements – Version 4 (Classified on Face/Disaggregated on Face)

Apex Apparel
STATEMENT OF CASH FLOWS
For the years ended December 31, 2007, 2006 and 2005

	2007	2006	2005
BUSINESS	(amounts in thousands)		
Operating			
Cash received from customers	$ 1,456,233	$ 1,571,219	$ 1,583,538
Cash paid for goods			
Materials	(718,731)	(786,807)	(730,892)
Freight and transportation	(21,045)	(20,788)	(20,258)
Labor	(41,938)	(44,284)	(43,174)
Handling	(10,106)	(11,011)	(13,940)
Other overhead	(27,839)	(26,657)	(24,902)
Cash received (paid) from settlement of cash flow hedge	(5,200)	20,800	1,040
Total cash paid for goods	(824,860)	(868,746)	(832,127)
Cash paid for selling activities			
Advertising and marketing	(155,199)	(158,696)	(146,790)
Warehousing	(38,412)	(39,104)	(38,864)
Retail expansion	(12,597)	(12,726)	(12,605)
Sales force compensation	(150,267)	(158,014)	(145,104)
Other	(86,466)	(79,262)	(45,169)
Total cash paid for selling activities	(442,942)	(447,802)	(388,533)
Cash paid for general and administrative activities			
Compensation	(15,340)	(17,102)	(15,977)
Rent	(43,591)	(41,418)	(34,119)
Other general and administrative	(19,926)	(34,235)	(31,562)
Capital expenditures	(3,794)	(3,805)	(3,762)
Acquisition of business, net of cash	(23,757)	(6,636)	(95,479)
Total cash paid for general and administrative activities	(106,407)	(103,196)	(180,899)
Cash flows from other operating activities			
Cash paid for other operating activities	(9,360)	(8,840)	(8,320)
Total cash flows from other operating activities	(9,360)	(8,840)	(8,320)
Net cash provided by operating activities	**72,665**	**142,635**	**173,659**
Investing			
Net (purchase) sale of money market and mutual funds	(1,116)	(4,585)	258
Rental income	21,291	23,886	22,588
Net cash provided by business activities	**92,840**	**161,935**	**196,505**
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash paid for interest	(7,867)	(7,872)	(6,629)
CASH FLOWS FROM INCOME TAXES			
Cash paid for income taxes	(42,071)	(55,475)	(81,389)
Change in cash before equity	**42,902**	**98,589**	**108,487**
CASH FLOWS FROM EQUITY ACTIVITIES			
Common stock repurchases	(19,448)	(20,500)	(32,728)
Issuance of common stock	6,838	17,063	11,272
Net cash used in equity activities	**(12,610)**	**(3,437)**	**(21,456)**
Net cash flows before effect of exchange rate	**30,292**	**95,152**	**87,030**
Effect of exchange rate changes on cash	987	2,216	(1,948)
Change in cash	**31,279**	**97,368**	**85,082**
Beginning cash	**242,672**	**145,304**	**60,222**
Ending cash	**$ 273,951**	**$ 242,672**	**$ 145,304**

**The accompanying notes are an integral part of these financial statements.*

Financial Statements – Version 4 (Classified on Face/Disaggregated on Face)

Zen Apparel
STATEMENT OF FINANCIAL POSITION
As of December 31, 2007 and 2006

	2007	2006
BUSINESS	(amounts in thousands)	
Operating		
Accounts receivable (net of allowance of 14,762 and 12,493, respectively)	$ 188,091	$ 204,016
Inventory, net	201,932	186,765
Prepaid expenses	41,572	42,306
Total short-term assets	**431,595**	**433,087**
Property plant and equipment (net of accumulated depreciation of 176,324 and 167,273, respectively)	310,644	315,404
Goodwill	44,840	39,717
Intangible assets, net	54,382	47,865
Leased asset	12,596	10,831
Total long-term assets	**422,462**	**413,817**
Accounts payable	(86,101)	(110,031)
Accrued payroll	(29,752)	(38,476)
Accrued consulting expenses	(32,435)	(36,100)
Accrued freight	(13,988)	(18,019)
Accrued rent	(9,662)	(7,680)
Accrued other	(23,066)	(22,459)
Derivative liabilities	(3,816)	(2,925)
Total short-term liabilities	**(198,820)**	**(235,690)**
Deferred compensation liability	(9,110)	(7,062)
Other long-term liabilities	(4,712)	(1,002)
Total long-term liabilities	**(13,822)**	**(8,064)**
Net operating assets	**641,415**	**603,150**
Investing		
Money market and mutual funds	21,698	21,211
Total investing assets	**21,698**	**21,211**
Net business assets	**663,113**	**624,361**
FINANCING		
Cash	263,414	233,338
Total short-term financing assets	**263,414**	**233,338**
Vendor notes payable	(5,000)	(5,000)
Debt	(120,000)	(120,000)
Total long-term financing liabilities	**(125,000)**	**(125,000)**
Net financing assets	**138,414**	**108,338**
INCOME TAXES		
Short-term		
Prepaid income taxes	17,361	12,353
Deferred tax asset	24,927	21,633
Income taxes payable	(19,215)	(49,938)
Accrued interest - uncertain tax position	(3,282)	-
Long-term		
Deferred tax asset	19,451	18,553
Other liabilities - uncertain tax position	(19,046)	-
Net income tax asset (liability)	**20,196**	**2,601**
Net assets	**$ 821,723**	**$ 735,300**
EQUITY		
Common stock and additional paid-in capital	(405,645)	(399,070)
Treasury stock	536,262	517,562
Retained earnings	(938,234)	(838,462)
Accumulated other comprehensive income	(14,106)	(15,330)
Total equity	**$ (821,723)**	**$ (735,300)**

**The accompanying notes are an integral part of these financial statements.*

Financial Statements – Version 4 (Classified on Face/Disaggregated on Face)

Zen Apparel
STATEMENT OF COMPREHENSIVE INCOME
For the years ended December 31, 2007, 2006 and 2005

	2007	2006	2005
BUSINESS	(amounts in thousands)		
Operating			
Sales	$ 1,479,545	$ 1,614,648	$ 1,565,681
Cost of goods sold			
Materials	261,369	285,235	268,529
Freight and transportation	103,395	105,199	101,500
Labor	209,892	219,204	209,542
Depreciation	31,342	34,204	32,201
Handling	66,484	70,660	67,133
Other overhead	136,771	139,158	134,265
Decrease in fair value of cash flow hedges	3,625	-	-
Total cost of goods sold	812,877	853,661	813,170
Gross Profit on Sales	**666,667**	**760,987**	**752,511**
Selling expenses			
Advertising and marketing	156,609	155,533	149,832
Warehousing	39,641	39,178	37,800
Store improvements	12,731	12,360	12,000
Sales force compensation	145,900	154,632	146,463
Other	73,713	77,079	73,231
Total selling expenses	428,593	438,782	419,326
General and administrative expenses			
Compensation	15,051	16,610	15,210
Rent	41,499	40,227	32,482
Depreciation	15,654	13,943	12,238
Other	20,168	33,590	28,903
Total general and administrative expenses	92,372	104,370	88,833
Other operating expenses			
(Gains) losses on futures contracts	(500)	8,400	(3,100)
Other expenses, net	1,852	(1,354)	539
Total other operating	1,352	7,046	(2,561)
Pretax operating income	**144,351**	**210,789**	**246,913**
Investing			
Realized gain on money market and mutual funds	1,063	1,084	990
Total business income	**145,414**	**211,873**	**247,903**
FINANCING			
Interest income	8,491	8,632	9,608
Interest expense	(7,656)	(7,666)	(6,273)
Net income before taxes	**146,249**	**212,839**	**251,238**
INCOME TAX EXPENSE	39,726	56,435	86,771
Net income	**106,523**	**156,404**	**164,467**
OTHER COMPREHENSIVE INCOME			
Foreign currency translation adjustment (operating)	1,401	2,376	(1,453)
Total other comprehensive income	**1,401**	**2,376**	**(1,453)**
Total comprehensive income	**$ 107,924**	**$ 158,780**	**$ 163,014**

**The accompanying notes are an integral part of these financial statements.*

Financial Statements – Version 4 (Classified on Face/Disaggregated on Face)

Zen Apparel
STATEMENT OF CASH FLOWS
For the years ended December 31, 2007, 2006 and 2005

	2007	2006	2005
BUSINESS	(amounts in thousands)		
Operating			
Cash received from customers	$ 1,455,107	$ 1,528,696	$ 1,552,046
Cash paid for goods			
Materials	(258,755)	(288,088)	(265,844)
Freight and transportation	(104,429)	(103,095)	(100,485)
Labor	(205,694)	(217,012)	(211,638)
Handling	(65,819)	(69,247)	(67,804)
Other overhead	(138,139)	(132,200)	(123,524)
Cash received (paid) from settlement of cash flow hedge	(5,000)	20,000	1,000
Total cash paid for goods	(777,835)	(789,641)	(768,295)
Cash paid for selling activities			
Advertising and marketing	(158,175)	(157,089)	(145,337)
Warehousing	(39,244)	(38,786)	(38,556)
Retail expansion	(12,476)	(12,236)	(12,120)
Sales force compensation	(147,359)	(153,085)	(140,605)
Other	(85,530)	(77,084)	(43,939)
Total cash paid for selling activities	(442,785)	(438,280)	(380,556)
Cash paid for general and administrative activities			
Compensation	(14,750)	(16,444)	(15,362)
Rent	(41,914)	(39,825)	(32,807)
Other general and administrative	(19,160)	(32,918)	(30,348)
Capital expenditures	(36,479)	(36,590)	(36,172)
Acquisition of business, net of cash	(22,843)	(6,381)	(91,807)
Total cash paid for general and administrative activities	(135,146)	(132,158)	(206,496)
Cash flows from other operating activities			
Cash paid for other operating activities	(9,000)	(8,500)	(8,000)
Total cash flows from other operating activities	(9,000)	(8,500)	(8,000)
Net cash provided by operating activities	**90,342**	**160,116**	**188,699**
Investing			
Net (purchase) sale of money market and mutual funds	(1,073)	(4,409)	248
Net cash provided by business activities	**89,269**	**155,707**	**188,947**
CASH FLOWS FROM FINANCING ACTIVITIES			
Cash paid for interest	(7,564)	(7,569)	(6,374)
CASH FLOWS FROM INCOME TAXES			
Cash paid for income taxes	(40,453)	(53,341)	(78,259)
Change in cash before equity	**41,252**	**94,797**	**104,314**
CASH FLOWS FROM EQUITY ACTIVITIES			
Common stock repurchases	(18,700)	(19,712)	(31,469)
Issuance of common stock	6,575	16,407	10,838
Net cash used in equity activities	**(12,125)**	**(3,305)**	**(20,631)**
Net cash flows before effect of exchange rate	**29,127**	**91,492**	**83,683**
Effect of exchange rate changes on cash	949	2,131	(1,873)
Change in cash	**30,076**	**93,623**	**81,810**
Beginning cash	**233,338**	**139,715**	**57,905**
Ending cash	**$ 263,414**	**$ 233,338**	**$ 139,715**

**The accompanying notes are an integral part of these financial statements.*

Appendix 3: PowerPoint package

[Slides 1-16 follow]

Financial Statement Presentation Experimental Research Study

IASB Meeting – September 17, 2009

FASB Meeting – September 21, 2009

Robert Bloomfield

Cornell University

Financial Accounting Standards Research Initiative

The views expressed in this presentation are my own and do not represent positions of the Financial Accounting Standards Board. Positions of the FASB are arrived at only after extensive due process and deliberations.

Presentation Overview

- **Background on Financial Accounting Standards Research Initiative (FASRI)**
- **Experiment on Financial Statement Presentation**
  - **Research Goals and Approach**
  - **Method**
  - **Results**
- **Conclusions**
  - **Information about classification and disaggregation are related, and should be located together (whether on the face of financial statements or in the notes)**
- **Discussion**

Background on FASRI

- **FASRI's Mission**
  - **Raise awareness of researchable standard setting issues among the academic research community**
  - **Support and conduct standard-setting research**
  - **Foster communication between academic researchers and standard setters**
- **Key activities**
  - **Online Round Table Discussions**
  - **FASRI.net Website and Blog**
  - **Research Studies**
- **Active Research Projects**
  - **Experiment on Financial Statement Presentation**
  - **Survey on Measurement**
  - **Experiment on Cash Flows**
  - **Synthetic Firm Research Platform**

Financial Statement Presentation: Research Goals and Approach

- **We focused on three goals that seemed likely to be relevant to FASB/IASB deliberations**
  - **Cohesive Classification by Activity (particularly Operating vs. Investing)**
  - **Disaggregation by Function and Nature (with specific attention to variable/fixed cost structure)**
  - **Liquidity and Financial Flexibility assessments**
- **A decision-usefulness approach complements comment letters and field test**
  - **60 credit analysts (8-9 years average experience)**
  - **Provide complete financial statements with different versions varying in classification and disaggregation**
  - **Elicit downgrade decisions, supporting forecasts and judgments, impressions of financial statements**

The Task: Comparing an Insourcer and Outsourcer

- **Our decision task targeted key goals of Financial Statement Presentation: to clarify liquidity, solvency and cost structure**
- **We created two firms that differ in only one way:**
  - **Zen is an apparel manufacturer that produces goods using its own factories**
  - **Apex is a similar firm, but has recently outsourced much of its production, retaining its fixed assets as rental/investment property "pending a strategic decision"**
- **Each analyst analyzed both firms, allowing for a powerful comparison**

Excerpt of Classified Statements of Financial Position

STATEMENTS OF FINANCIAL POSITION As of December 31, 2007		
	Apex (Outsourcer)	**Zen (Insourcer)**
	2007	**2007**
BUSINESS	(amounts in thousands)	(amounts in thousands)
Operating		
Accounts receivable (net of allowance)	$ 195,615	$ 188,091
Inventory, net	210,009	201,932
Prepaid expenses	43,235	41,572
Total short-term assets	**448,859**	**431,595**
Property plant and equipment (net of accumulated depreciation)	32,307	310,644
. . .		
Investing		
Money market and mutual funds	22,566	21,698
Property plant and equipment (net of accumulated depreciation)	290,763	N/A
Total investing assets	**313,329**	**21,698**
. . .		

Excerpt of Disaggregated Statements of Comprehensive Income

STATEMENTS OF COMPREHENSIVE INCOME For the years ended December 31, 2007 and 2006				
	Apex (Outsourcer)		Zen (Insourcer)	
	2007	2006	2007	2006
BUSINESS	(amounts in thousands)		(amounts in thousands)	
Operating				
Sales	$ 1,538,726	$ 1,679,233	$ 1,479,545	$ 1,614,648
Cost of goods sold				
Materials	711,615	779,017	261,369	285,235
Freight and transportation	20,837	21,212	103,395	105,199
Labor	42,794	44,731	209,892	219,204
Depreciation	3,260	3,557	31,342	34,204
Handling	10,208	11,236	66,484	70,660
Other overhead	27,563	28,060	136,771	139,158
Decrease in fair value of cash flow hedges	3,770	-	3,625	-

Four Versions of Presentation

		Disaggregation (by Function and Nature)	
		Disaggregated in Notes	**Disaggregated on Face**
Classification (by Activity)	**Classified in Notes**	Not Classified/Not Disaggregated (Version 1)	Not Classified/ Disaggregated (Version 2)
	Classified on Face	Classified/ Not Disaggregated (Version 3)	Classified/ Disaggregated (Version 4)

Theory of Presentation Effects

- **Inference Effects**
  - **Investors can infer that information is more relevant and reliable if recognized, rather than merely disclosed**
- **Interpretation Effects**
  - **Presentation (location, isolation, quantity, organization) can make information easier/harder to find.**
- **Information Effects**
  - **...the information that a purely rational user can extract from the financial reports given unlimited processing ability and financial sophistication, assuming that presentation does not alter the likely reliability or relevance of statements.**

Δ Expenses/ Δ Revenue
Outsourcer minus Insourcer

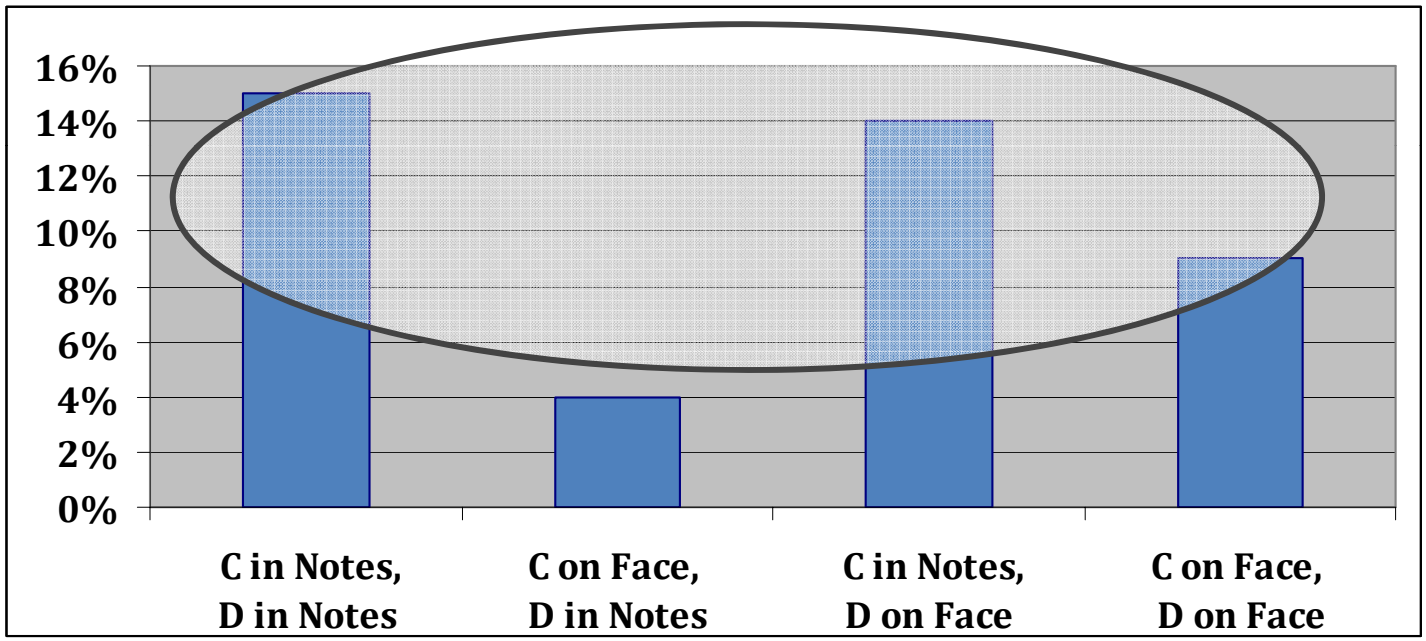

Figure 4
C = Classification, D = Disaggregation

% Analysts Citing Cost Structure Flexibility to Justify Downgrade

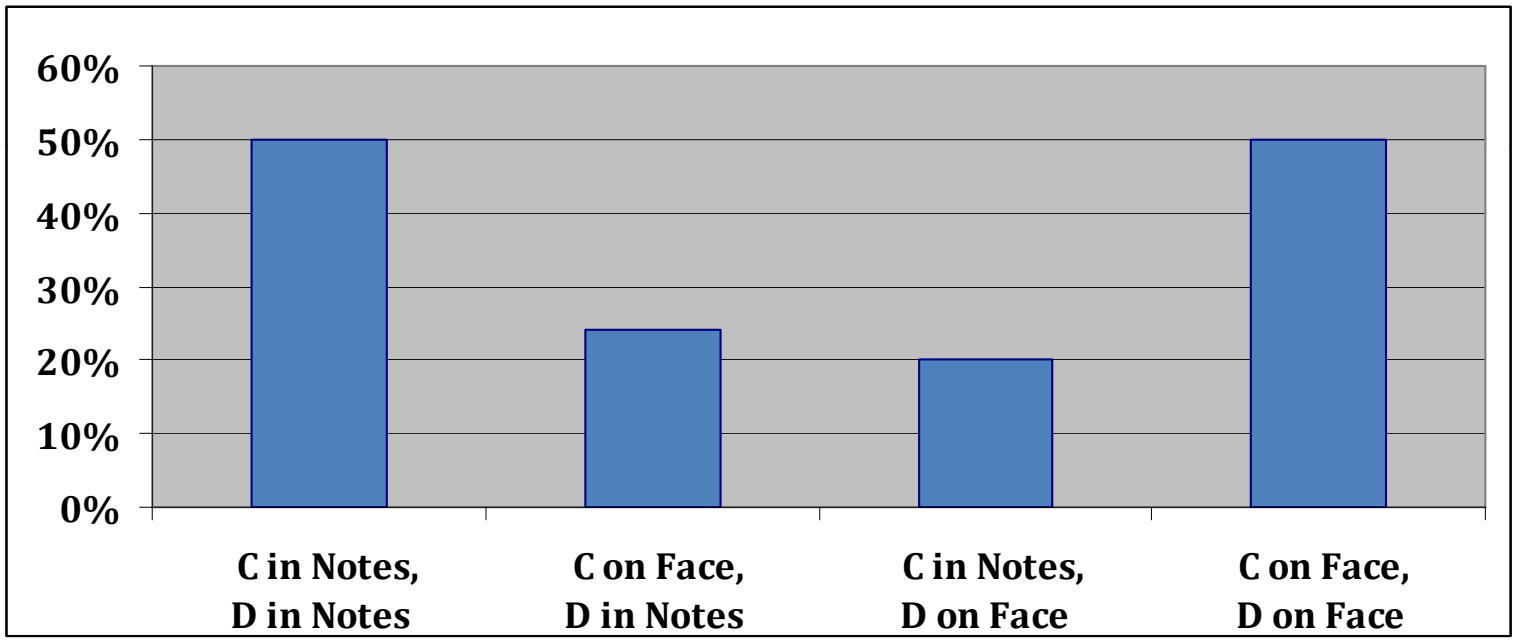

Figure 5
C = Classification, D = Disaggregation

% Analysts Citing Asset Disposition Flexibility To Justify Downgrade

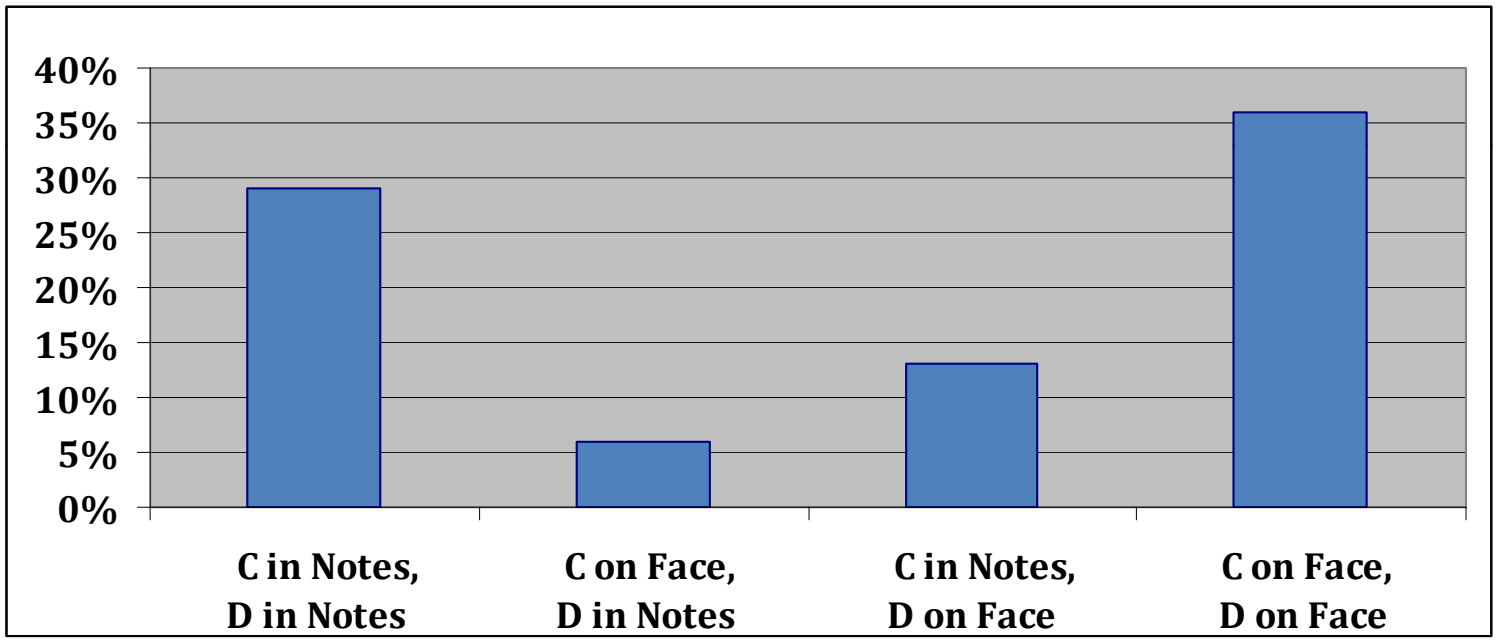

Figure 6
C = Classification, D = Disaggregation

% Analysts Citing Diversification To Justify Downgrade

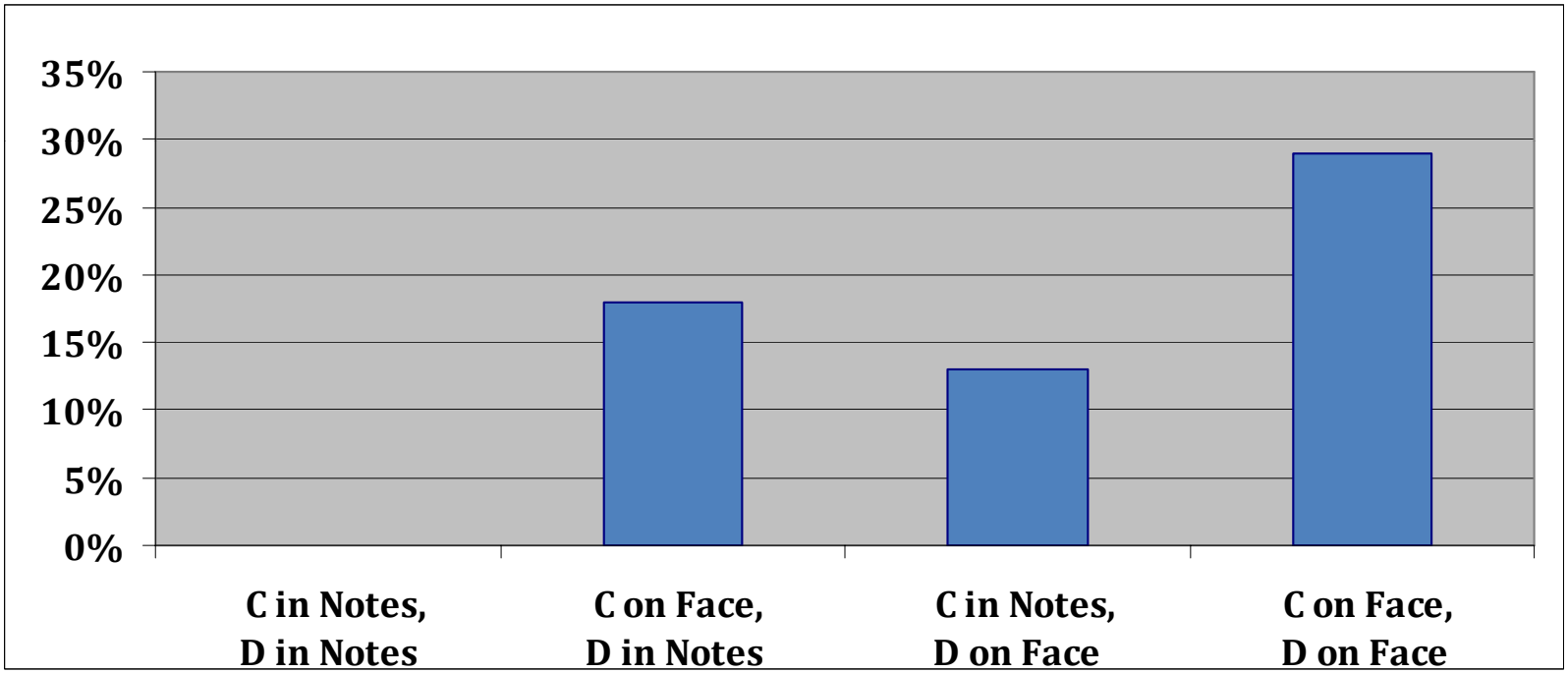

Figure 7
C = Classification, D = Disaggregation

Transparency Assessments

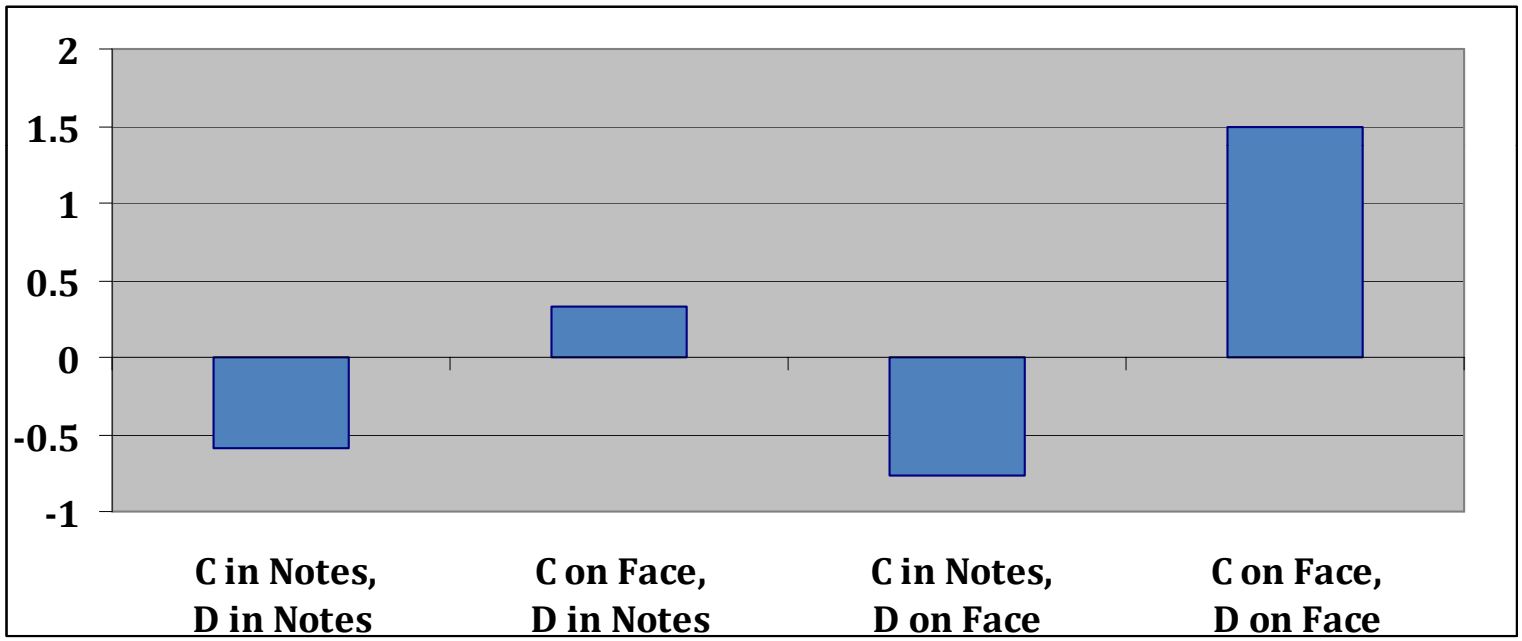

Figure 8
C = Classification, D = Disaggregation

% Analysts Stating that "Limited Detail" Hindered Assessments

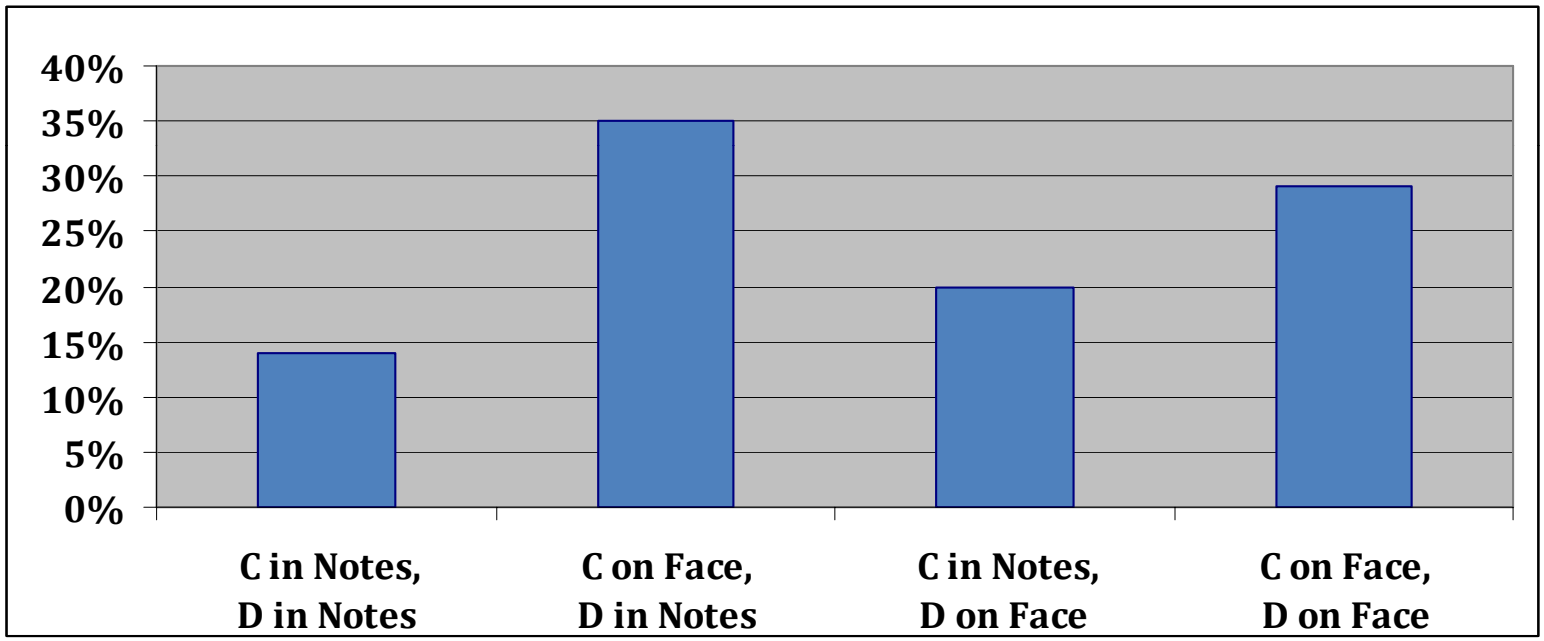

Figure 9
C = Classification, D = Disaggregation

Conclusions

- **Placing related information about classification and disaggregation together improves analysts forecasts and judgments**
  - **Placing that information together on the face of the financial statements improves some judgments, and also improves analyst perceptions of transparency**
- **Disaggregation on face, with classification in notes, is only modestly effective; Classification on face and disaggregation in notes is counterproductive**