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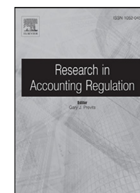

Regular paper

Financial statement comparability and segment disclosure

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ABSTRACT

Statement of Financial Accounting Standards (FAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FASB [1997]), reestablishes standards for how public business enterprises report segment information in financial statements. A prevailing criticism of FAS 131 is that it likely reduces financial statement comparability for firms with similar lines of business. This study estimates comparability of accounting disclosures surrounding the implementation of FAS 131 to examine potential variation in comparability associated with the segment reporting regime shift. Financial statement comparability is operationalized following the De Franco et al. (2011) accounting system comparability measure as the degree that firms have similar mappings for economic performance into financial statements. Results indicate decreased comparability for firms following FAS 131 adoption. Specifically, segment information reformulated according to how companies manage their businesses marginally limits this reduction in comparability, but greater segment information disaggregation through an increase in the number of reported segments attributed to FAS 131 application diminishes comparability overall. This study contributes to the standard setting process, as the FASB has assigned comparability to an important position in its conceptual framework and has made the goal of increasing comparability a vital component of its agenda that drives the need for accounting standards.

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1. Introduction

This study investigates whether the adoption of Statement of Financial Accounting Standards (FAS) No. 131, *Disclosures about Segments of an Enterprise and Related Information* (Financial Accounting Standards Board (FASB), 1997), is associated with reductions in financial statement comparability.[1] Financial statement comparability is commonly defined as the quality of information enabling users to identify similarities in and differences between two sets of economic phenomena in order to enhance usefulness (FASB, 2010). The FASB (1980, *Summary of Principal Conclusions*) suggests that comparable information is useful because the “significance of information, especially quantitative information, depends to a great extent on the user’s ability to relate it to some benchmark.”

FAS 131 is intended to help investors better understand an enterprise’s performance, and better assess future net cash flows, in order to make more informed judgments about the enterprise as a whole (FASB, 1997, Paragraph 3). However, critics of FAS 131 argue that the standard compromised comparability and reliability of segment reporting through subjective rules that are open to interpretation (e.g., McConnell et al., 1998; Springsteel, 1998). In addition, the FAS 131 Post-Implementation Review (PIR) states that although overall impressions of the segment reporting standard are positive, preferences still remain for the importance of better uniformity to improve comparability across companies (FAF, 2012).[2] Because financial statement comparability is a qualitative characteristic of accounting information (FASB, 1980), the primary focus of this study is on the relationship between segment reporting and comparability around FAS 131 adoption.

Financial statement comparability is operationalized following the De Franco, Kothari, and Verdi (2011) accounting system comparability measure as the degree that firms have similar mappings for economic performance into financial statements. This measure is used to provide evidence about the extent that comparability of accounting statements varies surrounding FAS 131 implementation.

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[1] The FASB Accounting Standards Codification (ASC) became effective September 15, 2009 and supersedes all outstanding FASs. FAS 131 is codified under ASC Topic 280, *Segment Reporting*, but this study refers to FAS 131 due to familiarity.

[2] The Post-Implementation Review process determined whether FAS 131 accomplished its stated purpose, evaluated FAS 131’s implementation and continuing compliance costs and related benefits, and provided recommendations to improve the FASB standard-setting process. The IASB also conducted a post-implementation review of IFRS 8, *Operating Segments*, which is converged with FAS 131.

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The empirical tests are divided into two parts. Using the same set of firms for both the pre- and post-FAS 131 periods, the first set of tests examines whether accounting comparability levels are different for firms reporting reformulated segments under FAS 131 application. The second set of tests considers comparability changes after firms adopt FAS 131 that are associated with increases in the number of segments disclosed under the revised standard (Berger & Hann, 2003; Ettredge, Kwon, Smith, & Zarowin, 2005).

Univariate results indicate lower levels of financial statement comparability in the post-FAS 131 period, suggesting that comparability levels are reduced for firms in the period following implementation of the revised segment standard. Multivariate tests also support this decrease in comparability around the regime shift. Specifically, segment information reformulated according to how companies manage their businesses marginally limits this reduction in comparability, but greater segment information disaggregation through an increase in the number of reported segments, attributed to FAS 131 implementation, diminishes financial statement comparability overall.

This study has practical implications for regulators and the policy making process. Segment reports have long been promoted as a means to understand more fully the operations and results of the total enterprise so that a better assessment of future prospects may be obtained (FASB, 1976), where segmental data must be comparable in order to achieve this goal (FASB, 1980). The FASB (2010, BC3.33) indicates that analyzing the effect of standards such as FAS 131 on comparability is a way to gauge the FASB's success.[3] These views are consistent with the FASB assignment of comparability to an important position in its conceptual framework found in *Conceptual Framework for Financial Reporting* (FASB, 2010) and with the FASB making the goal of increasing comparability an important component of its agenda that drives the need for accounting standards. An empirical evaluation of FAS 131′s effect on financial statement comparability is compatible with the FASB recognizing the importance of comparable accounting information (FASB, 1997, Paragraph 63) in the ongoing refinement of its conceptual framework and is an objective of the recent FASB Segment Reporting Project.[4]

The remainder of the paper proceeds as follows. Section 2 summarizes the segment disclosure standards. Section 3 reviews relevant literature and formulates the hypotheses. Section 4 provides the research design and defines the variables used in the empirical tests. Section 5 describes the sample selection and presents descriptive statistics. Section 6 reports results from the empirical analyses, and Section 7 concludes. The appendices expand on the research design and empirical results, and provide additional analyses with robustness checks.

2. Summary of segment disclosure

Financial analysis of a diversified company can be especially complicated given that distinctly different activities aggregated into a single set of financial statements can make an informed projection of future performance more difficult. Over the years, an increasing number of business enterprises have broadened the scope of their activities into different industries, foreign countries, and markets. To assist progress in the analysis and evaluation of financial data, several groups in the mid-1960s pushed the accounting profession to require disclosure of segment information. In December 1976, the FASB instructed companies to apply FAS 14, *Financial Reporting for Segments of a Business Enterprise* (FASB, 1976), which disaggregated an enterprise's consolidated financial information and provided instructions for the presentation within corporate financial statements of segment descriptions and information that comprise each reporting entity based on industry groupings and geographic location.

Over time, however, financial analysts consistently requested that financial statement data be disaggregated to an even greater extent than existed under FAS 14 guidance, with many analysts stating that they found the industry approach of FAS 14 helpful but inadequate (FAPC, 1992). In June 1997, the FASB issued FAS 131, which superseded FAS 14 and became effective for financial statements for periods beginning after December 15, 1997. The method the FASB chose for determining what information to report is referred to as the management approach, arising from the determination of disclosed segments from the structure of the enterprise's internal organization. The intention was to help financial statement users more completely understand an enterprise's performance and more effectively estimate future net cash flows, in order to be better informed about the enterprise in its entirety.

3. Literature review and hypotheses development

3.1. Financial statement comparability

Textbooks on financial statement analysis state that rational investing decisions involve evaluating a firm's future opportunities as compared to the opportunities of other similar firms and frequently illustrate techniques to increase comparability across firms' financial statements in order to better assess individual firm performance (e.g., Palepu & Healy, 2007; Penman, 2006; Revsine, Collins, & Johnson, 2004; Wild, Subramanyam, & Halsey, 2006). The textbooks also suggest that enhancing comparability of disclosures across firms is likely to result in more accurate valuations of individual firm performances (Dye & Sunder, 2001).

Empirical studies have found many benefits of financial statement comparability. De Franco et al. (2011) suggest that comparability lowers the cost of acquiring information and increases the quantity and quality of firm-information available to analysts. Kim, Kraft, and Ryan (2013) find that comparability reduces debt market participants' uncertainty about and pricing of firms' credit risk. Wang (2014) provides results that indicate comparability as a direct mechanism for facilitating transnational information transfer within harmonized accounting standards. Moreover, several papers have focused on benefits from improved comparability specifically through mandatory IFRS adoption (e.g. Brochet, Jagolinzer, & Riedl, 2013; DeFond, Hu, Hung, & Li, 2011; Neel, 2016).[5]

Further studies associate comparability with increased valuation accuracy (Young & Zeng, 2015), reduced information asymmetry in the syndicated loan market (Fang, Li, Xin, & Zhang, 2016), lower cost of equity capital (Imhof, Seavey, & Smith, 2017), better acquisition decisions (Chen, Collins, Kravet, & Mergenthaler, 2018), and lower audit effort and increased audit quality (Zhang, 2018). Additionally, Little, Muoghalu, and Robinson (1995) find reduced comparability for firms with loss contingencies, and the Francis, Pinnuck, and Watanabe (2014) results indicate increased comparability from audit style within Big-4 clientele.

[3] The IASB also emphasizes the importance of financial statement comparability in its central theme of a 5-year agenda that ends in 2021, where better communication is prefaced along with improving financial statements through increased comparability.

[4] In September 2017, the FASB decided to add the Segment Reporting Project to its future technical agenda, stating that the objective of the project is to undertake improvements to the segment aggregation criteria and disclosures to provide financial statement users with more useful information for decision making regarding reportable segments.

[5] Benefits include increased Tobin's Q, liquidity, analyst forecast accuracy, analyst forecast agreement, and cross-border investment, and reduced ability of insiders to exploit private information.

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