



Contents lists available at ScienceDirect

Advances in Accounting, incorporating Advances in International Accounting

journal homepage: www.elsevier.com/locate/adiac

The effects of the method used to present a complex item on the face of a financial statement on nonprofessional investors' judgments☆

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ARTICLE INFO

Article history:

Received 24 January 2016

Received in revised form 26 July 2016

Accepted 26 July 2016

Available online xxxx

Keywords:

Financial reporting
Presentation format
Information complexity
Disaggregation
Defined pension cost
Cognitive load theory

ABSTRACT

Our study is motivated by standard setters' (FASB, 2010; IASB, 2010a) interest in better understanding the effects of item complexity and disaggregation of financial information on users' decision processes. We examine whether the method used to present a complex item on a financial statement influences nonprofessional investors' judgments. We also examine whether disaggregation influences how different levels of item complexity are associated with judgments. Using a 2×2 between-subjects experiment, we manipulate variables representing presentation method (disaggregation versus aggregation) and level of item complexity (which is defined pension cost with high versus low volatility). With a sample of 114 nonprofessional investors, we find that when the complex item defined pension cost is disaggregated into its component parts and displayed in different sections of the statement of comprehensive income, nonprofessional investors acquire more information about the item and are able to more accurately understand the function of the item. This, in turn, helps the nonprofessional investors decide whether the information is useful in certain judgments. Additionally, we find that when a complex item is disaggregated, nonprofessional investors place even greater weight on their perceptions of level of item complexity in certain judgments. The results of this study are of value to managers, standard setters, and investors. For instance, results suggest that disaggregating a complex item across a financial statement can help nonprofessional investors learn how the component(s) driving a complex item relates to different economic events, improving their ability to understand and process the information in their judgments.

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1. Introduction

If nonprofessional investors find items on financial statements too complex, it can hinder their judgments and decisions. While standard setting bodies suggest how information is presented on financial statements can mitigate some of this complexity (FASB, 2010; IASB, 2010a) a fundamental question remains in the financial reporting literature as to whether the presentation method used to recognize a complex item in the body of a financial statement provides users with decision-useful information (Hopkins, 1996).

The purpose of the current study is to examine this issue by investigating whether disaggregating a complex item into its component parts and displaying the separate parts in various sections of a financial statement influences nonprofessional investors' judgments. The motivation for this research comes from two sources. First, standard setters have expressed interest in better understanding the effects of item complexity and methods used to present financial statement information on users' decision processes (Barth, 2000; Bonner, 2008; FASB, 2010;

IASB, 2010a). Second are two issues raised in statements IAS 1 *Financial Statement Presentation* and IAS 19 *Employee Benefits*. The first issue is whether there are differences in nonprofessional investors' use of information when the components of a complex item are disaggregated versus aggregated on the face of a financial statement. Differences could arise as a result of disaggregation increasing visibility and providing information about how the parts that comprise the complex item relate to different economic events. The second issue is whether such disaggregation impacts how different levels of item complexity are associated with judgments. Since disaggregation increases visibility of the components comprising the complex item it could make analysis of the item even more difficult.

Accounting research has established fairly well that presentation matters. For instance, studies (e.g. Hirst & Hopkins, 1998; Hopkins, 1996; Maines & McDaniel, 2000) show that both professional and nonprofessional users can be influenced by whether specific items are presented in different financial statements and/or one section of a financial statement versus another section of the same financial statement. Studies (e.g. Bloomfield, Hodge, Hopkins, & Rennekamp, 2015) also show that presenting more disaggregated information on the face of the financial statements can be beneficial to users. However, these studies have not investigated whether nonprofessional financial statement user

☆ Data availability: Data used in this study are available from the authors upon request.

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judgments are influenced by how a single complex item is presented or whether disaggregating a complex item into its component parts and displaying the separate parts in various sections of a financial statement can impact their judgments.

Notably, there is disagreement on the usefulness of reporting a complex item on a more disaggregated basis. For example, in arguments surrounding how defined pension costs should be reported, proponents suggest that disaggregating defined pension costs and reporting components in different sections of the financial statements will help users understand how the components affect a firm's financial performance and financial position, as well as how the cost may affect a firm's future cash flows (IASB, 2010b). However, opponents argue that because of the complexity surrounding the volatile and interlocking nature of the assumptions used to measure defined pension cost, disaggregation may not provide beneficial information to users (Napier, 2008). The current study explores this disagreement to inform the debate on whether disaggregating a complex item across a financial statement is useful in investor related judgments made by nonprofessional investors.

Whereas, complex information often imposes a higher cognitive load on financial statement users' limited working memory, the theory of cognitive load suggests that one way to reduce this load is to present complex information in meaningful ways to help individuals better understand and process the information (Sweller, Van Merriënboer, & Pass, 1998). We examine this idea by disaggregating a complex item into its component parts and displaying the parts in various sections of a financial statement in an effort to determine whether enhancing visibility and displaying components related to different economic events affect nonprofessional investors' judgments. Related to this we also examine whether enhancing the visibility of complex items through disaggregation influences how the level of item complexity is judged by nonprofessional investors.

To answer our research questions, we conduct a 2×2 between-participants experiment with 114 nonprofessional investors. In our setting, we manipulate variables representing presentation method (disaggregated versus aggregated) and level of item complexity (a complex item, defined pension cost, with high versus low volatility).¹ Our dependent variables are nonprofessional investors' acquisition, evaluation, and weighing of a complex item's (defined pension cost) information in investment related judgments.

The results of our study show that when a complex item is disaggregated across the statement of comprehensive income, nonprofessional investors are able to acquire more information about the complex item and are able to more accurately evaluate the function of the item. Further we find that disaggregation helps nonprofessional investors decide whether the information is useful in certain of their judgments (e.g. belief that management is effective in managing the complex items). We also find that when a complex item is disaggregated, nonprofessional investors place greater weight on their perceptions of level of item complexity in certain judgments (e.g., belief that the historical pattern of the complex item will continue in the future). We argue that this moderating effect results from a change in cognitive load; in that disaggregation of the complex item decreases the cognitive load, thus providing a more useful reporting format for the investor to make decisions.

Unexpectedly, we do not find a connection between nonprofessional investors' actions (i.e. accuracy in evaluations) and their reported perceptions (i.e. beliefs) related to the complex item. Additionally, we do not find that disaggregation is useful in all nonprofessional judgments. Similar to prior research (e.g. Bloomfield et al., 2015), our results indicate that additional research is required to more fully understand whether nonprofessionals are capable of making the "right decision" regardless of presentation method, or whether item complexity can be just too great to impact beliefs and/or certain judgments.

The results of our study suggest that standard setters and managers should consider how complex items are displayed. In particular, we find disaggregation can be useful in acquiring and evaluating complex item information. Disaggregation of information also appears to have limited usefulness in some investment judgments made by nonprofessional investors.

Our study also contributes to financial reporting literature by adding to what we know about disaggregation, level of item complexity, and factors of cognitive load. Specifically, while prior research (e.g. Plumlee, 2003) suggests that financial statement users may discount higher levels of item complexity in judgments, results from our study show that some financial statement users (e.g. nonprofessional investors) weigh a complex item differently in certain evaluations and judgments if the information is presented in a format that reduces cognitive load.

Additionally, while prior research suggests that disaggregation can be useful in judgments because it helps users identify factors responsible for changes in major aggregates such as net assets (Barton & Waymire, 2004), results from our study provide two possible explanations as to how disaggregating a complex item across a financial statement can be useful in nonprofessional investors' judgments. Disaggregation increases visibility and this can help users understand the component(s) driving the impact of a complex item without having to split their attention to search other sources (e.g. the notes) in an effort to learn about the complex item, thus reducing users' cognitive load. Further, disaggregation across a financial statement increases the level of detail on the financial statement and this increase in detail can help users learn how the components of a complex item relate to different economic events, improving their ability to understand and process the information, which can also reduce their cognitive load.

The remainder of our paper proceeds as follows. In the next section we discuss the institutional background surrounding disaggregation, item complexity, and disaggregating a complex item. We develop hypotheses in our third section. Subsequent to hypotheses development are sections that describe the research method and present findings. We conclude with a discussion of the results, limitations, and outlook for future research.

2. Institutional background

In the past the FASB and IASB have indirectly addressed the topic of how to present a complex item in a financial statement by providing reporting guidance for specific types of items such as employee benefits, financial instruments, and leases, all of which are considered to be complex in the sense that the items require lengthy standards that are viewed by many to be contentious (FASB, 1985; IASB, 2011; Weidman & Weir, 2004). More recently, the FASB and the IASB considered reporting requirements for the complex item, defined pension costs, which is the focus of this paper.

To date, however, the FASB and IASB have not directly addressed how to present a complex item nor have they defined a complex item. Additionally, they provide little guidance on the type of, or extent to which financial statement information should be disaggregated. Nonetheless, with an increasing demand from creditors and investors for more useful accounting information, and with the increasingly complex nature of some reported items the FASB and the IASB are showing strong interest in addressing issues of presentation related to both item complexity and disaggregation (FASB, 2010; IASB, 2010a,c).

In the exposure draft of the recently amended IAS 19 *Employee Benefits*, the FASB and the IASB considered disaggregating the changes in the defined benefit obligation and the fair value of plan assets into three functional cost items on the statement of comprehensive income. Defined benefit service cost would be reported as an operating item. Finance cost (i.e. net interest cost) related to the net defined benefit liability (asset) would be recognized as an operating-finance item and remeasurement cost would be included as other comprehensive income

¹ Defined pension cost is a single line item that we have disaggregated into its component parts to represent the various transactions comprising defined pension cost.

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