Financial Information and Rational Irrationality

by Joel Wagoner, CPA, MBA, CMA, CFM

Abstract: The Financial Accounting Standards Board and the International Accounting Standards Board are scheduled to release a joint exposure draft proposing significant changes to how businesses present their financial statements. Two major objectives of the proposed financial statements are "disaggregation" and "cohesiveness.'" Disaggregation means, simply, that information on the financial statements will be broken into more detail than is currently done. Cohesiveness means that financial information will be presented so that a reader will be able to relate specific revenue or expenses on the income statement to specific assets or liabilities on the balance sheet and to specific cash flows on the statement of cash flows.

Forty years ago, Swedish economist and politician Staffan Linder gave us *The Harried Leisure Class,* a study of the relationship between money and time.[1] *The Harried Leisure Class* never became as famous as the Thorstein Veblen classic its title was derived from. But its depiction of life as time becomes scarcer than money describes our 21st century world uncannily well. Two dilemmas that the accounting profession currently faces could be taken directly from its pages.

It was Linder who explained the paradox of "rational irrationality": the rational decision maker of economic theory requires time and money to gather and analyze the information necessary to make a rational decision. But the time and money required to obtain and analyze this information may be more valuable than the benefit of an informed decision. If it is, then our rational decision maker is better off making an uninformed decision than wasting scarce time bothering to learn the marginal costs and utility that classical economic theory would have him/her base his/her decision on.

Suppose that you are an investor considering the purchase of a corporation's stock. How much time are you willing to spend researching the corporation? How much money would you want the corporation to spend producing the financial statements, disclosures, and other information you would use in deciding whether or not to make the purchase? Money that the corporation spends producing financial information is money a corporation no longer has; the money spent reduces the value of your investment.

The Cost-Benefit Principle

The Financial Accounting Standards Board (FASB) has acknowledged this trade-off between the cost and the value of information since its inception in 1973. The cost-benefit principle is made explicit in the FASB's Conceptual Framework: "Before a decision is made to develop a standard, the Board needs to satisfy itself...that a standard that is promulgated will not impose costs on the many for the benefit of a few...the Board cannot cease to be concerned about the cost-effectiveness of its standards. To do so would be a dereliction of its duty and a disservice to its constituents."[2]

The cost-benefit principle is about to take on new meaning for all who prepare or use financial statements. At approximately the time that this issue of the Journal goes to press, the FASB and International Accounting Standards Board (IASB) are scheduled to release a joint exposure draft proposing significant changes to how businesses present their financial statements.

A Draft of a Draft

A "staff draft" of the forthcoming exposure draft—literally a draft of a draft—was released to the public on July 1, 2010.[3] The staff draft includes descriptions of the proposed financial statements, explanations of the rationale for the format of the proposed statements, and two sets of examples of financial statements—one for a manufacturer and one for a financial services company.

The financial statements proposed in the staff draft are markedly different from the financial statements currently required. The proposed financial statements are even significantly different from those that were earlier proposed in a 2008 discussion paper.[4]

The FASB and IASB had solicited comments to the 2008 discussion paper from the public. They then ran a pilot study in which 31 companies produced the financial statements proposed in the discussion paper. Forty-three analysts reviewed the financial statements that had been prepared as proposed in the discussion paper. All who produced and all who analyzed the financial statements in the pilot study provided their analysis of the value of the information contained within them.[5]

Did the boards consider the comments that they'd received and the results of the pilot study when they developed the staff draft? Apparently so. Much was changed from the earlier discussion paper. The staff draft includes 55 pages of explanations of the boards' decisions of what is to be presented and how it is to be presented. The explanations refer repeatedly to the comments of respondents to the discussion paper and to the observations of the participants in the pilot study.

What Is Being Proposed?

Two major objectives of the proposed financial statements are "disaggregation" and "cohesiveness." Disaggregation means, simply, that information on the financial statements will be broken into more detail than is currently done. Cohesiveness means that financial information will be presented so that a reader will be able to relate specific revenue or expenses on the income statement to specific assets or liabilities on the balance sheet and to specific cash flows on the statement of cash flows.

With the new presentation format, each financial statement will be divided into a business section and a financing section. The business section will itself be divided into operating and investing categories.[6]

The operating category of the business section will include all assets and liabilities that produce revenue or incur expenses when combined with other assets and liabilities. The investing category will include assets and liabilities that produce revenue or incur expenses independent of other assets and liabilities.[7]

This distinction between the operating and investing categories differs from what was proposed in the 2008 discussion paper. The discussion paper proposed that the operating category would include all assets and liabilities related to an entity's "core" business, and the investing category would include all assets and liabilities unrelated to the core business.[8]

When respondents to the discussion paper requested guidance on how to distinguish core from noncore businesses, the FASB and IASB realized that the distinction would be problematic. They therefore changed the distinction between operating and investing to whether assets and liabilities are combined with other assets and liabilities in their usage.[9]

The financing section will include all debt and equity financing of an entity.[10] Long-term liabilities other than debt, such as pension liabilities and lease obligations, will be presented in an "operating finance" subcategory within the operating section.[11] Assets that are restricted for the satisfaction of liabilities in the operating finance subcategory will also be presented in the operating finance subcategory.[12]

Assets and liabilities related to discontinued operations will be shown in a separate section, as will tax-related assets and liabilities (payables and deferred taxes), and assets or liabilities that cannot be reasonably categorized into any one of the other sections. All told, assets and liabilities will be presented in as many as seven separate sections within the balance sheet.

Within each of these sections, assets and liabilities will be divided into more separate line items than they are currently. Assets or liabilities will be presented separately in the balance sheet "when the function, nature, or measurement basis of an item or aggregation of similar items is such that separate presentation is relevant to an understanding of the entity's financial position."[13] This is the essence of disaggregation.

The income statement and the statement of cash flows each should be divided into comparable sections, categories, and subcategories as the balance sheet. Revenue and expenses within categories of the income statement, and cash receipts and disbursements within categories on the statement of cash flows, should relate to the comparable categories of assets and liabilities on the statement of financial position. This is the essence of cohesiveness.

Other Proposed Changes in the Staff Draft

Financial statement preparers and users will want to be aware of other major changes that are proposed in the staff draft.

The classification of assets and liabilities as current or noncurrent will be replaced by short-term and long-term. This is not a mere renaming. Current assets and liabilities are presently defined as those that will be realized or satisfied within one year or one operating cycle, whichever is longer. Short-term assets and liabilities will be those that will be realized or satisfied within one year, regardless of the length of the operating cycle.[14]

Cash will always be presented in the operating category of the business section on the balance sheet. This will be done regardless of whether it is received through operating, investing, or financing activities.[15] This is an exception to the principle of cohesiveness, as it will be presented in the appropriate category on the income statement and statement of cash flows. Cash equivalents will no longer be presented in the same line item as cash.

The direct method of presenting the statement of cash flows will be required.[16] A reconciliation of operating income to net cash flows from operating activities, similar to an indirect method statement of cash flows, will also be required.[17]

Extraordinary items will no longer be reported.[18] However, it will be required that "unusual" or "infrequently occurring" items be disclosed in the notes.[19]

How soon will these changes occur? It will likely take several years. The FASB and IASB will allow several months for anyone who wishes to comment on the exposure draft, then will take the time to consider all of the comments that they receive. When the boards issue a final pronouncement, it will be necessary to allow reporting entities adequate time to develop the capability of producing the required information for two reporting years.

The Dilemmas Facing the Accounting Profession

The proposed financial statements will become controversial as more accountants become aware of them. This past July, I spoke about the proposed financial statements at a continuing education seminar. The general response from the audience of CPAs, mostly private practitioners, was overwhelmingly negative.

The audience's complaints were not unwarranted. The redesign of financial statements will necessitate modifications to accounting systems. Those accounting systems that do not capture the nature, function, and measurement bases of assets and liabilities will have to be modified further. Retraining will be necessary for those who prepare and for those who use financial statements.

Will there be sufficient benefit to the users of the new financial statements to justify the increased costs of producing and using them? This is the first dilemma that faces the accounting profession.

Few would argue that financial statements, as they presently exist, adequately provide the information that investors should consider before deciding whether or not to invest in a corporation. But if the reaction of the seminar attendees is typical, and I expect that it is, fewer wish to incur the cost in time and effort to develop financial statements that may provide more (and presumably better) information.

Fewer yet are willing to express an opinion on the matter. The FASB received only 57 responses to the 2008 discussion paper. Of the 57 responses, 11 were from academics. Only 25 were from preparers of financial statements; 9 were from auditors and 7 from users of financial statements.[20]

There is a significant cost in (scarce) time and effort to reading the FASB's proposals and commenting on them. But the FASB has shown that it considers the comments that it receives before its proposals become pronouncements. The stakes in this pronouncement will be great, as what is being proposed is nothing less than a thorough redefinition of what must be presented in financial statements and how it must be presented.

This is the second dilemma that the accounting profession faces. We have the opportunity to influence a decision that will determine the value of what we do, and the amount of time and effort that will be necessary to do it. Is the time and effort required to influence this decision more valuable than its outcome? ■

Note: *On November 1, 2010, the FASB announced, "[A]t their October 2010 joint meeting, the [FASB and IASB] acknowledged that they do not have the capacity currently to devote the time necessary to consider the information learned during outreach activities.... Consequently, the Boards decided to not issue an Exposure Draft in the first quarter 2011 as originally planned.*

"Board members and staff will meet with the project working group in December 2010 to discuss the cost and benefit information received during outreach activities and possible ways to move forward. The Boards will return to this project when they have the requisite capacity. This is expected to be after June 2011."[21]

This announcement lends itself to further discussion of Linder's writings as they relate to the dilemmas facing the accounting profession.

Joel Wagoner, CPA, MBA, CMA, CFM, is assistant professor of accounting at Arcadia University, Glenside, PA. Mr. Wagoner earned his MBA from Regis University. He currently serves on the executive committee of the Greater Philadelphia Chapter of the Pennsylvania Institute of CPAs. He may be reached at wagonerj@arcadia.edu.

(1) Staffan B. Lindner, *The Harried Leisure Class* (New York: Columbia University Press, 1970.)
(2) Concepts Statement No. 2, "Qualitative Characteristics of Accounting Information" (Norwalk, CT: Financial Accounting Standards Board, 1980): ¶ 143–144.
(3) FASB, "Staff Draft of an Exposure Draft on Financial Statement Presentation" (2010); (http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820952978&blobheader=application%2Fpdf (visited August 21, 2010).
(4) FASB, "Discussion Paper: Preliminary Views on Financial Statement Presentation" (2009); (http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1175801986226 (visited August 21, 2010).
(5) FASB Staff Draft, ¶ BC21–BC27.
(6) Ibid., ¶ 62.
(7) Ibid., ¶ 72–73, and 81.
(8) FASB Discussion Paper, ¶ 2.64.
(9) FASB Staff Draft, ¶ BC101–BC102.
(10) *Ibid.*, ¶ 84.
(11) *Ibid.*, ¶ 74–76.
(12) *Ibid.*, ¶ 77.
(13) *Ibid.*, ¶ 119.
(14) *Ibid.*, ¶ BC128–BC129.
(15) *Ibid.*, ¶ 117.
(16) *Ibid.*, ¶ 170.
(17) *Ibid.*, ¶ 172.
(18) *Ibid.*, ¶ BC168.
(19) *Ibid.*, ¶ BC170.
(20) FASB, "Comment Letter Summary" (2009), ¶ 1; http://www.iasb.org/NR/rdonlyres/791DE489-E887-4652-9DD1-79789C36F032/0/FSP0907b17Cobs.pdf (visited August 21, 2010).
(21) http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2F ProjectUpdatePage&cid=900000011110 (visited November 15, 2010).