

FINANCIAL STATEMENT DISCLOSURES OF DERIVATIVES: DOES FORMAT AFFECT ANALYSTS' INFORMATION PROCESSING?

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ABSTRACT

Statement of Financial Accounting Standards (SFAS) No. 133 requires publicly held companies to report the fair-market value of derivatives in their balance sheets effective for all fiscal years beginning after June 15, 2000 (FASB 1998, 1999). In addition, under certain circumstances, companies will have to include changes in the fair value of derivatives in earnings. Currently, companies are allowed to disclose information on derivatives in the footnotes to the financial statements. This study investigates whether disclosure of a gain or loss on derivatives in the income statement, as opposed to a footnote, affects financial analysts' information processing.

Consistent with expectations, the results of this study indicate that when the derivative gain/loss was included in the income statement, analysts included the gain/loss significantly more often in their P/E ratios, and were more likely to list the derivative as a factor affecting their investment recommendation, than when the derivative gain/loss was disclosed in a footnote. Moreover, analysts included losses on derivatives in their P/E ratios significantly more often than gains, and were more likely to list the derivative as a factor affecting their investment recommendation when there was a loss as opposed to a gain. In addition, within the loss condition, analysts were more likely to recommend to sell the stock when the derivative was disclosed in the financial statements rather than the

footnotes. Finally, the results of verbal protocol analysis suggest that participants are less likely to consider information regarding derivatives when it is contained in footnotes.