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Impression management through minimal narrative disclosure in annual reports

Sidney Leung [a], Lee Parker [b,*], John Courtis [a]

[a] City University of Hong Kong, Hong Kong
[b] RMIT University, Melbourne, Australia

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ABSTRACT

The literature on the impression management of discretionary narrative disclosures has largely focused on *selectivity* in the *presentation* and *content* of information. We argue that selectivity involves 'including' or 'omitting' certain items of information – 'concealment' (Merkl-Davies & Brennan, 2007 Figure 1) – which can be achieved either by manipulating the presentation of narrative disclosures (selectivity in the presentation of information), or by omitting narrative disclosure (selectivity in the content of information). In this study, we examine the concealment behaviour of minimal narrative disclosure (MND) in annual reports within the context of impression management. Based on a sample of publicly listed firms in Hong Kong, we first compare narrative disclosure items between MND firms and other sample firms and find that MND is more prominent in the domains of operating review and company overview, objectives and strategies. After controlling for the costs associated with disclosure, demand for external financing, market competition and political cost, our multivariate regression analysis shows that firms with poor performance and a higher risk of financial distress are more likely to engage in MND behaviour. We also find that MND firms exhibit deteriorations in firm performance in the subsequent year. Our findings are consistent with MND in annual reports being a deliberate impression management strategy to conceal information and explanations about persistently poor firm performance and future prospects to distract investors' attention away from a firm's weakness or negative news.

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1. Introduction

Corporate financial disclosure, including narrative disclosures in corporate annual reporting, has been a longstanding preoccupation of accounting researchers and policymakers. As a crucial input to corporate governance, transparency and accountability, financial reporting quality has been a focus of attention for investors, regulators and the broader community.

Policymakers have long emphasised the importance of narrative disclosures in helping investors understand a company's financial performance and risks, as illustrated by the following statement released by the Securities and Exchange Commission (1987), '*The Commission has long recognis*ed the need for a narrative explanation of the financial statements, because a numerical presentation and brief accompanying notes alone may be insufficient for an investor to judge the quality

* Corresponding author. 124 La Trobe Street, 3000 Building: 80, Level: 11, Room: 101, City Campus, Melbourne, Victoria, Australia.
E-mail addresses: acsleung@cityu.edu.hk (S. Leung), lee.parker@rmit.edu.au (L. Parker), john.courtis@bigpond.com (J. Courtis).

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of earnings and the likelihood that past performance is indicative of future performance'. The Financial Accounting Standards Board (FASB) is also concerned with the quality of discretionary disclosure in business reports. In 2001, the FASB issued a Steering Committee Report entitled, 'Improving business reporting: Insights into enhancing voluntary disclosure'. Discretionary disclosure, if used for impression management, has the potential to impair the quality of financial reporting, which can result in capital misallocation. Thus, managers' motivations and strategies for discretionary narrative disclosures remain an important area of accounting research.

The literature on narrative disclosure strategies in corporate documents has generally assumed that these discretionary disclosure strategies are used either for *useful incremental information* or for *impression management* (see Merkl-Davies and Brennan (2007) for a review of narrative disclosure strategies). The incremental information school is rooted in agency theory and presumes that managers voluntarily disclose information to reduce information asymmetries between managers and outsiders, or to increase information usefulness to lower the cost of capital, improve managerial reputation and increase managerial compensations (e.g., Baginski, Hassell, & Hillison, 2000; Botosan & Plumlee, 2002). The impression management school, however, explains managerial disclosure strategies as opportunistic behaviour where managers selectively disclose information for self-interest and manipulate the *content* and *presentation* of information in corporate documents with the purpose of distorting readers' perceptions of corporate performance and prospects (e.g., Aerts, 2005; Brennan, Guillamon-Saorin, & Pierce, 2009; Courtis, 2002, 2004; Godfrey, Mather, & Ramsay, 2003; Merkl-Davies & Brennan, 2007). Previous studies have shown that managers are more likely to attribute bad news to external factors (excuses) and good news to internal causes to improve investor perceptions of a firm's prospects (e.g., Baginski et al., 2000; Barton & Mercer, 2005).

In a corporate reporting context, impression management is regarded as intending to purposely control and manipulate users' impressions of accounting and narrative information (Clatworthy & Jones, 2001, 14(3): 311). Merkl-Davies and Brennan (2007, Figure 1) summarise impression management strategies into two types of behaviour: concealment and attribution. *Concealment* can be achieved either by obfuscating negative outcomes or emphasising positive organisational achievements. *Attribution* manifests itself by claiming positive organisational outcomes to managerial ability and internal factors, and attributing negative outcomes to external factors (excuses).

Merkl-Davies and Brennan (2007) indicate that impression management strategies that focus on content analysis are conducted by (i) disclosure choices or (ii) the presentation of information by means of 'bias' and 'selectivity', and that *selectivity* involves omitting or including certain items of information. Previous impression management research has focused primarily on *selectivity* in the *presentation of information*. For example, certain language characteristics may be selected to positively shape investors' perceptions of the firm (Smith & Taffler, 2000; Sydserff & Weetman, 2002). Aerts (2005) documents self-serving behaviour in the selection of narrative disclosures to attribute positive outcomes to a firm's own actions and negative outcomes to external factors (excuses, causality denials and justifications), and management employment of rhetorical manipulation to obfuscate bad news (Cho, Roberts, & Patten, 2010). However, selectivity achieved by omitting narrative disclosures as a concealment strategy is not well understood in the current impression management literature.

In this study, we focus on selectivity in neglecting narrative information in the annual report to explore the phenomenon of concealment strategy through minimal narrative disclosure (MND). We use the disclosure-index approach to develop a comprehensive disclosure corpus (checklist) for voluntary narrative disclosures in annual reports that are in tandem with investors' need to make informed decisions. Based on the checklist, actual disclosure scores are calculated and firms with a total disclosure score of less than 10% of the maximum possible score are designated as MND firms. To the best of our knowledge, no previous study has provided evidence of what narrative information is hidden by MND firms. In this study, we first document evidence on specific narrative disclosure items that MND firms are more likely to omit from annual reports compared with non-MND firms. The results of empirical regression analyses show that MND firms exhibit poorer performance and have higher financial-distress risks after controlling for information asymmetry and the costs associated with disclosure, such as demand for external financing, cost of capital, market competition and political cost. We also find that MND firms are more likely to exhibit lower Tobin's Q ratios and lower returns on assets in the subsequent year. The overall evidence is consistent with MND being a concealment strategy to distract investors' attention away from the firm's persistent weakness in performance and bad news.

There is ample support for the importance of such an inquiry. First, despite continuing calls for increased corporate disclosure and transparency by regulators and investors, the existence of MND in annual reports is not uncommon, and the phenomenon of concealment in annual reports is not well understood. Nondisclosure in annual reports warrants an investigation because the deliberate omission of useful relevant information could result in misinformed beliefs with associated potential economic loss incurred by investors and shareholders. Second, we use the disclosure checklist approach in identifying MND firms in the examination of concealment strategies. Thus, this study bridges two bodies of literature: the voluntary disclosure literature, based on disclosure indices, and the impression management literature. Third, our study extends the literature on the concealment or obfuscation of narrative disclosure, which identifies the strategy of obfuscating bad news by *syntactical, reading ease* or *rhetorical* manipulations as a concealment strategy through MND. Finally, identifying the items of information that MND firms are significantly more likely than non-MND firms to omit can provide a foundation for regulators' further development of corporate reporting guidelines, legislation and related enforcement. Such development may be directed towards the greater disclosure of specific items for improving the overall quality of corporate financial reporting, transparency and accountability.

The remainder of this paper is organised as follows. Section 2 reviews the concept of impression management and minimal narrative disclosure as a concealment strategy and describes Hong Kong's institutional environment. We develop

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