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# Guiding through the Fog: Financial statement complexity and voluntary disclosure<sup>☆</sup>

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## ABSTRACT

A growing literature documents that complex financial statements negatively affect the information environment. In this paper, we examine whether managers use voluntary disclosure to mitigate these negative effects. Employing cross-sectional and within-firm designs, we find a robust positive relation between financial statement complexity and voluntary disclosure. This relation is stronger when liquidity decreases around the filing of the financial statements, is stronger when firms have more outside monitors, and is weaker when firms have poor performance and greater earnings management. We also examine the relation between financial statement complexity and voluntary disclosure using two quasi-natural experiments. Employing a generalized difference-in-differences design, we find firms affected by the adoption of complex accounting standards (e.g., SFAS 133 and SFAS 157) increase their voluntary disclosure to a greater extent than unaffected firms. Collectively, these findings suggest managers use voluntary disclosure to mitigate the negative effects of complex financial statements on the information environment.

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*"I am raising the question here and internally at the SEC as to whether investors need, and are optimally served, by the detailed and lengthy disclosures about all of the topics that companies currently provide in the reports they are required to prepare and file with us. [...] In some cases, lengthy and complex disclosure may indeed be a direct result of the Commission's rules."* – SEC Chair Mary Jo White, speech to the National Association of Corporate Directors, October 15, 2013.

## 1. Introduction

Financial statements provide a structured medium for firms to disclose accounting information and to supply discussion and analysis that explains financial results. However, the growing complexity of accounting rules and explanatory language surrounding firms' financial statements has led to concerns about the effectiveness of these disclosures in communicating information to shareholders. Many scholars and practitioners argue that the increasing complexity of these disclosures

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makes it difficult for management to bring any given item to investors' attention.<sup>1</sup> Consistent with these arguments, a growing literature documents that complex financial statements negatively affect the information environment. For example, experimental and empirical evidence suggests that both professional and non-professional investors fail to internalize information in complex financial statements, and that more complex financial statements reduce price efficiency and increase uncertainty.<sup>2</sup>

With respect to managing their information environment, firms have at their disposal a variety of disclosure mediums beyond financial statements that can be used to achieve an optimal information environment (e.g., management forecasts, 8-K filings, press releases). While the literature noted above documents the potential negative effects of complex financial statements, it does not explore whether managers use alternative disclosure channels to mitigate these effects.

Theoretically, the relation between financial statement complexity and voluntary disclosure depends on how the complexity arises. On the one hand, complex financial statements might reflect an intentional choice by managers to obfuscate and hide information from investors, for example poor performance (e.g., Li, 2008). In this case, managers choose to accept the negative effects of financial statement complexity (as their personal benefits from a low quality information environment exceed the costs) and are not expected to provide investors with supplemental information outside of the required financial report. In this case, we expect no relation—or perhaps even a negative relation—between financial statement complexity and voluntary disclosure.

On the other hand, complex financial statements might reflect the complexity of the firm's business transactions and associated reporting standards. In this case, the negative effects of financial statement complexity do not reflect an intentional choice by managers. Consequently, if the complexity of the financial statements causes the quality of the information environment to decline, economic theory suggests managers will use other disclosure channels to improve the information environment.<sup>3</sup> For example, when firms engage in complex transactions or apply complex reporting standards, investors may have difficulty understanding the content of the 10-K. Observing these difficulties (or perhaps in some cases anticipating them), managers may provide additional disclosures to help investors understand the performance implications of these transactions. In this case, we expect a positive relation between financial statement complexity and voluntary disclosure.

We examine the relation between financial statement complexity and voluntary disclosure using multiple measures of these constructs and using three distinct sets of tests. Following an extensive prior literature, we measure financial statement complexity using the readability and length of the firm's 10-K filing (e.g., Li, 2008), and we measure voluntary disclosure using the frequency of management forecasts (e.g., Balakrishnan et al., 2014a). To ensure our inferences are not unique to a specific voluntary disclosure channel, in subsequent analyses we confirm that our results are robust to using 8-K filings and firm-initiated press releases as alternative measures of voluntary disclosure.

In the first set of tests, we examine the relation between financial statement complexity and voluntary disclosure using both cross-sectional and within-firm designs. A key advantage of using a within-firm design is that it helps alleviate concerns that our measures of financial statement complexity capture omitted, firm-specific characteristics (e.g., industry practices) and controls for persistence in both independent and dependent variables. We find (1) a positive association between financial statement complexity and voluntary disclosure over periods ranging from one month to twelve months after the filing of the 10-K, (2) within a firm, increases in financial statement complexity are associated with increases in voluntary disclosure, and (3) financial statement complexity of a given 10-K has a greater association with voluntary disclosure after the 10-K filing than voluntary disclosure before the 10-K filing.

In our second set of tests, we examine cross-sectional variation in the relation between financial statement complexity and voluntary disclosure. In particular, we examine how this relation varies with: (1) the change in liquidity at the time the 10-K is filed, (2) the intensity of external monitoring, and (3) firm performance and earnings management. Such tests are helpful because, although our main tests examine voluntary disclosure locally around 10-K filings, one might still harbor a concern that a correlated omitted variable might independently affect both complexity of the financial statements and the demand for voluntary disclosure. Finding consistent evidence across multiple predictions makes it less likely that our collective results are attributable to alternative explanations or specific research design choices.

We find that the relation between financial statement complexity and voluntary disclosure is stronger when there is a greater reduction in liquidity around the filing of the 10-K, and when firms have more outside monitors. We also find that the relation between financial statement complexity and voluntary disclosure is weaker when firms have poor performance and greater earnings management. Collectively, these findings suggest that the positive relation between financial statement complexity and voluntary disclosure is strongest (weakest) in firms where managers have greater (lesser) incentives to mitigate the informational problems created by complex financial statements.

In our third set of tests, we use two quasi-natural experiments to examine the relation between financial statement complexity and voluntary disclosure. Specifically, we use a generalized difference-in-differences design to examine changes in voluntary disclosure around the adoption of SFAS 133 (Accounting for Derivatives) and the adoption of SFAS 157 (Fair Value

<sup>1</sup> See for example Bloomfield (2002), Hirshleifer and Teoh (2003), Miller (2010), KPMG (2011), and Monga and Chasan (2015).

<sup>2</sup> For empirical evidence see You and Zhang (2009), Miller (2010), Lehavy et al. (2011), Lee (2012), Bonsall and Miller (2013), Callen et al. (2013), Lawrence (2013), Loughran and McDonald (2014), Bozanic and Thevenot (2015), and Lang and Stice-Lawrence (2015). For a review of experimental evidence see Libby et al. (2002).

<sup>3</sup> See for example Proposition 3 of Jung and Kwon (1988), Corollary 2 of Verrecchia (1990), and related discussions in Einhorn (2005), and Bagnoli and Watts (2007).

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