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Earnings management and annual report readability ☆

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ABSTRACT

We explore how the readability of annual reports varies with earnings management. Using the Fog Index to measure readability (Li, 2008), and focusing on the management discussion and analysis section of the annual report (MD&A), we predict and find that firms most likely to have managed earnings to beat the prior year's earnings have MD&As that are more complex. This disruption of the overall pattern of readability increasing with the level of earnings found in Li (2008) challenges the ontological explanation that good news is inherently easier to communicate, and shows that obfuscation contributes to making disclosures more complex.

> *"For more than forty years, I've studied the documents that public companies file. Too often, I've been unable to decipher just what is being said or, worse yet, had to conclude that nothing was being said.*
>
> *[…]*
>
> *Maybe we simply don't have the technical knowledge to grasp what the writer wishes to convey. Or perhaps the writer doesn't understand what he or she is talking about. In some cases, moreover, I suspect that a less-than scrupulous issuer doesn't want us to understand a subject it feels legally obligated to touch upon."*

Warren Buffett.
Preface of "A Handbook of Plain English Handbook" – SEC.

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1. Introduction

In a typical corporate report, the textual narrative represents the great majority of the disclosure— an average of 80% of an annual report, for instance—versus the remainder that consists of numbers and representations of quantitative data. The clarity of this large component of mandatory disclosure is crucial to understanding and to interpreting the information contained in the report. The U.S. Securities and Exchange Commission (SEC) has been very forthright about the overly complex corporate reports. Christopher Cox, Chairman of the SEC, suggested using direct measures of narrative clarity to enforce plain English communication. SEC seems to believe that "the jargon of lawyers has taken over" and the trend towards hard-to-read disclosures is due to the fact that "the main purpose of the drafting exercise has shifted from informing investors to insuring the issuer and the underwriter against potential claims" (SEC, 2007). In this paper, we examine whether managers use of complex disclosures goes beyond the presence of "legalese", but also whether they use complex disclosure to hide information from investors.

The seminal work of Li (2008) explored the relationship between the readability of annual reports and financial performance. Borrowing the Fog Index from computation linguistics, where a higher reading on the Fog Index indicates disclosures that are more difficult to understand, Li finds a negative relationship between Fog and the level of earnings. It is unclear, however, whether this result is due to managers providing complex disclosures to obfuscate bad performance or that bad news is simply harder to be communicated (Bloomfield, 2008). To further explore these alternative explanations, obfuscation or ontology, and to better understand managers' use of complex disclosures, we look at instances in which firms are more likely to have managed earnings upwards to meet or beat an earnings target (Burgstahler and Dichev, 1997). In these cases, although firms are releasing good news about meeting a benchmark, they have incentives to hide the tools used to achieve it, as suggested by Warren Buffett. In other words, when reported performance differs from underlying fundamentals, we expect managers to try to make it harder for investors to identify such earnings management behavior and the underlying performance. Our results suggest that the readability level of financial disclosures goes beyond the one derived from the ontological explanation of good vs. bad news being disclosed. Instead, we find that managers strategically use corporate disclosure to mislead or to influence investors' understanding of firm's value.

Our study is motivated by the importance and richness of the textual component of financial disclosures. The SEC highlighted the importance of textual disclosures when it issued a set of rules requiring plain English disclosures. Christopher Cox, Chairman of the SEC, went further and suggested "just as the Black-Scholes model is commonplace when it comes to compliance with the stock option compensation rules, we may soon be looking to the Gunning-Fog and Flesch-Kincaid models to judge the level of compliance with the plain English rules." If readability is going to be used as a measure of compliance, then we should understand the factors that affect how managers choose the level of readability.

Our analysis focuses on the readability of the management discussion and analysis (MD&A) section of the annual report—a section that is required by law but also a medium in which managers have discretion over how to present an explanation of the company's business, financial conditions, and results of operation. As opposed to conference calls and press releases, the structure and content of MD&As are fixed; consequently managers are *"legally obligated to touch upon"*(Warren Buffett) subjects they likely avoid in other disclosures.

The earnings benchmark we use is the prior year's earnings (rather than earnings forecasts or zero earnings) because anecdotal evidence suggests that management's discussions in the annual report are more likely to compare and contrast performance in the current fiscal year with that in the prior year (or years). Forecasted earnings, whether by sell-side analysts or by management, are seldom referenced in annual reports. Zero and small positive earnings events are relatively infrequent, so we reserve this benchmark for supplemental analyses.[1] Moreover, small or zero earnings changes mean that performance this year was similar to that in the previous year so little explanation is expected by readers and provided by management. This idea is the basis for our null hypothesis–firms should provide disclosures that are easy to understand when their performance does not change much from previous year.

The findings are consistent with our hypotheses. Controlling for the relationship between Fog and the overall earnings level as well as other known factors, we find robust evidence that Fog is higher for firms that meet or just beat prior year's earnings (MBE). We further identified firms that are more likely to have managed earnings to meet a benchmark. We use model-free methods, and several accruals and real activities methods to identify firms that are more likely to have managed earnings. We find that firms more likely to have managed earnings to meet the benchmark by a couple of cents provide more complex disclosures than firms that either miss the benchmark or were less likely to have engaged in earnings management to exceed the benchmark; this finding holds both when the comparison group is the broad cross-section of firms as well as when the comparison group is a matched group of firms with characteristics similar to the firms with suspected earnings management.

Our conclusions remain the same when we add firm fixed effects that control for firm-specific characteristics, such as the

[1] Three examples showing that firms focus on the zero earnings change benchmark in their MD&A are as follows (underlining added). Standard Pacific Corporation (31/12/2011): *"For the year ended December 31, 2011, we reported a net loss of $16.4 million, or $0.05 per diluted share,* ***compared to a net loss of $11.7 million, or $0.05 per diluted share, in 2010****."* Human Genome Sciences (31/12/2005): "*Net Income (Loss). We recorded a net loss of $239.4 million, or $1.83 per share, for the year ended December 31, 2005****, compared to a net loss of $242.9 million, or $1.87 per share, for the year ended December 31, 2004****."* TII Network Technologies (31/12/2009): *"Net income in 2009 was $73,000 or $0.01 per diluted share,* ***compared to net income of $578,000 or $0.04 per diluted share in 2008****."*