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The influence of business strategy on annual report readability

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ABSTRACT

Concerns about the complexity of firm disclosures have prompted regulators to initiate projects to improve the readability of annual reports. We investigate business strategy as a determinant of annual report readability. As business strategy fundamentally determines a firm's product and market domain, technology, and organizational structure, it influences a firm's operating complexity, environmental uncertainty and information asymmetry. Consequently, business strategy frames the level, wording, and complexity of disclosures. We capture a firm's business strategy based on the Miles and Snow (1978) strategic typology and measure 10-K readability with Li's (2008) Fog index. We find that firms pursuing an innovation-oriented prospector strategy have less readable 10-Ks relative to firms pursuing an efficiency-oriented defender strategy. We also find that prospectors display more negative and uncertainty tones while defenders exhibit more litigious tone in their 10-Ks. Our study provides useful insights to policy makers as it suggests that efforts to improve annual report readability may be limited for some firms given that business strategy is a fundamental determinant of readability and pronouncements accommodating different strategic orientations are not feasible.

1. Introduction

As the scope of reporting requirements has widened to a broader narrative including corporate governance, sustainability and responsibility, remuneration, enhanced disclosure regimes and long form audit reports, the complexity and materiality of information in annual reports is being questioned. This has prompted the international financial reporting community to initiate projects on streamlining annual reports to improve their readability. Responses in the US include the Securities and Exchange Commission (SEC)'s 1998 Plain English Mandate (SEC Rule 421 (d)) and the Financial Accounting Standards Board (FASB)'s ongoing Disclosure Framework project, initiated in 2009, with the objective of making financial statement disclosures more effective, coordinated and less redundant. Disclosure reform is also on the agenda of the International Accounting Standards Board (IASB) and the UK Financial Reporting Council (FRC).¹ Form 10-Ks report accounting numbers prepared in accordance with accounting standards, as well as unstructured textual narratives disclosing accounting policies and describing business operations and financial performance. When preparing annual reports, including the financial reports and accompanying notes, and the management discussion and analysis (MD &A) sections, managers have discretion over the content emphasized, and the language and writing style used in their narratives (Henry and Leone, 2016; Loughran and McDonald, 2014). Li (2010) argues that unstructured textual narratives in annual reports

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E-mail addresses: e.lim@deakin.edu.au (E.K. Lim), kchalmers@swin.edu.au (K. Chalmers), dean.hanlon@monash.edu (D. Hanlon).¹ Better Communication in Financial Reporting is a key pillar of the IASB's work agenda for 2017–2021. In March 2017, the IASB issued Discussion Paper DP/2017/1 Disclosure Initiative – Principles of Disclosure.<https://doi.org/10.1016/j.jaccpubpol.2018.01.003>

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exhibit irregularities, ambiguities, and managerial opportunism. Form 10-K volume of pages and footnote disclosures has also increased, up 16 percent and 28 percent respectively over the six-year period 2004–2010, with evidence of disclosure repetition and redundancy (Iannoconi and Sinnett, 2011). Investors rely on information in 10-Ks to infer trading and pricing decisions (Cazier and Pfeiffer, 2016; Griffin, 2003; Huddart et al., 2007) and complex disclosures, including less readable annual reports, can impair users' ability to process information, and hence affect their judgment and decision making (Li, 2008; Miller, 2010; You and Zhang, 2009). Consequently, policy makers and various capital market participants are increasingly concerned about the readability of 10-Ks that underpins the understandability and decision usefulness of information contained therein.

Such concern has spawned research on the association between readability and individual firm characteristics synonymous with operating complexity and uncertainty.² In this study, we investigate whether business strategy explains 10-K readability. By fundamentally influencing a firm's operating complexity and environmental uncertainty (Bentley et al., 2013; Hambrick, 1983a; Higgins et al., 2015; Miles and Snow, 1978), business strategy warrants attention in explaining 10-K readability as it is a comprehensive measure that captures firm-level complexity not necessarily captured by individual firm characteristics. As Bentley et al. (2013) suggest, business strategy is a broad underlying measure that “captures a construct that is greater than the sum of its parts” (p.805).

Specifically, we explore the 10-K readability of innovation-oriented prospector firms and efficiency-oriented defender firms. Pursuing innovation increases firms' exposure to operating complexity and environmental uncertainty due to the risky nature of research and development (R&D), and unpredictable and constantly changing consumer choices (Miles and Snow, 1978; Naiker et al., 2008), which can increase disclosure complexity and incentives to obfuscate information. Conversely, firms pursuing a more stable cost-efficient strategy relying less on innovation, are less exposed to operating complexity, environmental uncertainty, and costly failure, resulting in less complex disclosures and lower incentives to obfuscate information. Our proposition is that prospectors have less readable 10-Ks relative to defenders.

With the accounting standard setting community focused on improving the readability of financial reports, our study is motivated by considering the influence of strategy on communication and how this may restrict the success of reporting reforms to a subset of firms. White (2013), former SEC Chair, notes the importance of broadening considerations of disclosure complexity as accounting standards and volume of mandated disclosures may not be the sole contributing factor. Zahra et al. (2005) and Bentley et al. (2013) highlight the importance of establishing direct antecedents of financial reporting outcomes rather than merely identifying their perfunctory indicators. Bentley et al. (2013) associate prospectors with financial reporting irregularities, and Bentley Goode et al. (2018) relate prospectors to a richer external information environment. Our study complements these studies by investigating whether business strategy influences the readability and tone of 10-K information.

We classify a firm's strategic orientation using Miles and Snow (1978, 2003) typology and following the methodology of Bentley et al. (2013) which relies on a collective of firm characteristics: research intensity, marketing and advertising efforts, historical growth, operational efficiency, capital intensity, and organizational stability. We obtain the Fog index, a proxy for 10-K readability, from Feng Li's website.³ Using 24,817 firm-year observations spanning 1994–2011, we find that prospectors have less readable 10-Ks relative to defenders. Investigating if business strategy influences disclosure sentiment or tone using Loughran-McDonald sentiment measures, we find that prospectors display greater negative and uncertainty tones while defenders use more litigious tone in their 10-Ks. Greater use of negative and uncertainty tones in the 10-Ks can explain the lower readability of prospectors' 10-Ks. Our results are robust to using alternative measures of readability including the Kincaid and Flesch indexes. We do not, however, find an association between business strategy and 10-K length, suggesting that linguistic index and length capture different facets of reporting and disclosure complexity. Further, we show that in both sub-samples of good and poor performing firms, prospectors have less readable 10-Ks relative to defenders, suggesting that business strategy plays a more fundamental role than earnings performance in explaining 10-K readability.

Our study offers insights for policy makers seeking to enhance the readability and reduce the complexity of annual reports. Christopher Cox (2007), former SEC Chair, suggests the use of the Fog index to measure compliance with the SEC's plain English initiatives.⁴ Our study suggests that policy makers' efforts to improve and assess annual report readability may be limited to influencing a subset of firms with a strategic orientation not requiring, or incentivizing, complex communications.

Our study also contributes to the readability and business strategy literatures. We document that business strategy is associated with annual report readability, controlling for individual firm complexity variables. Cazier and Pfeiffer (2016) show a firm's operating complexity, disclosure redundancy, and residual disclosure (i.e. 10-K length unexplained by a firm's operating complexity or redundancy) as determinants of 10-K length. However, amongst the firm characteristics examined, Cazier and Pfeiffer (2016) find that R&D does not explain variation in 10-K length. We show that while business strategy (including R&D) is not associated with 10-K length, it is associated with 10-K readability. Our study also provides a plausible explanation to Bentley Goode et al.'s (2018) finding that prospectors (defenders) have higher (lower) analyst following since lower (greater) 10-K readability can increase (reduce) the demand for analyst services. Our findings also imply that strategy should be controlled for in future studies to mitigate the concern of omitted correlated variables (Li, 2010, p. 158).

The remainder of this paper proceeds as follows. Section 2 reviews the literature on annual report readability and business strategy, and formulates the hypothesis to be tested. Section 3 presents the research design. Section 4 reports sample selection,

² Such individual firm characteristics include firm size, market to book ratio, R&D, age, and geographic and operating segments (Cazier and Pfeiffer, 2016; Kumar, 2014; Laksamana et al., 2012; Li, 2008; Lo et al. 2017).

³ The data for 10-K readability are made available by Feng Li at <http://webuser.bus.umich.edu/feng/>.

⁴ The UK FRC also encourages the use of plain English to enhance financial information understandability (Financial Reporting Council, 2011).

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