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Annual report readability and corporate agency costs

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ABSTRACT

Annual reports are the main sources of information for outside investors' investment decisions and enable shareholders to supervise the management. Difficulties with the readability of these reports may therefore have serious consequences. Using 19,221 firm-year observations of Chinese A-share listed firms from 2001 to 2015, we investigate the association between annual report readability and corporate agency costs, where readability is proxied by report file length and/or file size. We find that firms with better annual report readability experience lower agency costs, and the negative association between readability and agency costs is more pronounced in firms with higher external audit quality, internal control quality or analyst coverage. These results hold after several robustness checks. The positive effect of annual report readability is stronger in private firms than in state-owned enterprises, and becomes stronger after the implementation of new accounting standards in 2007. Readable annual reports can help in monitoring corporate insiders' opportunistic behavior and thus reduce agency costs.

1. Introduction

Readability is an important attribute of textual information and has been examined extensively in various fields. Research into the importance of readability has been conducted in areas including the military,

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medicine and law (Bonsall and Miller, 2017; DuBay, 2004). The value of the information in the text can only be fully realized with a high level of readability. The issue of readability has increasingly become a focus in capital markets in recent years. The changes in requirements for corporate information disclosure have resulted in a significant increase in the quantity of information disclosed and attracted the attention of regulators and investors. In 1998, the U.S. Securities and Exchange Commission (SEC) issued the *Plain English Disclosure* and *A Plain English Handbook: How to Create Clear SEC Disclosure Documents*, which aim to help public firms improve the readability of their disclosed information and to help investors better understand the information.

Theoretically, information disclosure announcements such as annual reports are an important communication bridge between management and outside stakeholders (e.g., shareholders) in joint-stock companies due to the separation of ownership and management. Outside investors and minority shareholders can learn about a company's financial status, performance and cash flow through its annual reports and thus evaluate the prospects for corporate growth and management competence. However, the increasing deterioration in levels of readability has adversely affected the communication function of corporate annual reports in recent years. One consequence of the improvements in the information disclosure systems of capital markets is that the information disclosed in annual reports includes many professional terms and specific notes and also much non-financial information, which makes them increasingly complicated and hard to understand in listed companies, particularly those in China. One major trend is that the length of corporate annual reports is increasing (see Fig. 1), and thus the readability of these reports has become an intractable problem, particularly considering the current explosion in the volume of information and shallow network reading. The economic consequences of annual report readability have therefore attracted the attention of scholars and regulators alike.

Many studies find that annual report readability can affect the quality of resulting information. For example, poor readability may result in serious earnings management problems, poor earnings persistence, low analyst forecast quality, weak market reactions to annual reports and a high risk of stock price crashes (Ertugrul et al., 2017; Kim et al., 2017a, 2017b; Lang and Stice-Lawrence, 2015; Lawrence, 2013; Li, 2008; Lo et al., 2017; Rennekamp, 2012). Most of these studies are based on the context of the U.S. or other English-speaking countries, and few have explored the economic consequences of annual report readability in China. You and Yi (2010) and Ji et al. (2016) initially discuss the readability problem of internal control reports and corporate social responsibility reports in China. Studies also mainly focus on the direct effects of annual report readability, such as the transmission or hiding of information, and few have explored the potential impact of readability on stakeholders in achieving their economic goals. In terms of the usefulness of annual reports in decision making, their core value is to help investors make scientific economic decisions. These reports are the main information sources through which shareholders learn about management competence and firm perfor-

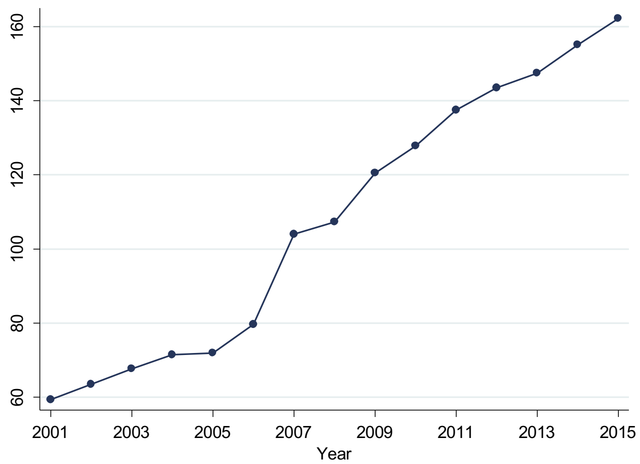

Fig. 1. The average number of pages of the annual reports of China's listed companies between 2001 and 2015.

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