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An Analysis of the Qualitative Characteristics of Management Commentary Reporting by New Zealand Companies

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Abstract

The narrative section of annual reports has considerable value to its user groups, such as financial analysts and investors (Barlett & Chandler 1997; International Accounting Standards Board (IASB) 2006; Tiexiera 2004). This narrative section including chairpersons'/presidents’ statement contains twice the quantity of information than the financial statements section (Smith & Taffler 2000). However, the abundance of information does not necessarily enhance the quality of such information (IASB 2006). This issue of qualitative characteristics has been long foregone by researchers. This issue has attracted the attention of IASB (2006). Following the dearth in research in regard to qualitative characteristics of reporting this paper explores whether investors’ required qualitative characteristics as outlined by the IASB (2006) have been satisfied in the management commentary section of New Zealand companies’ annual reports. Our result suggests that the principal stakeholders’, that is, investors’ qualitative characteristics requirements have been partially met in this section of annual reports. The qualitative characteristic of ‘relevance’ and ‘supportability’ have been satisfied in more annual reports compared to that of ‘balance’ and ‘comparability’.

Key Words: Management commentary, New Zealand companies, qualitative characteristics

JEL Classification: M40.

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Introduction and Background

Annual Reports are a medium of communication (Barlett & Chandler 1997; Courtis 1995) that have enjoyed considerable attention by many researchers (Abeysekera & Guthrie 2004; Beattie & Jones 2000). Kent and Ung (2003) for example employed a disclosure index based on statements made by management in either the director or chairman’s report or reports on individual business regarding future operating outcomes, all gleaned from the annual reports. They based their disclosure index on the annual report because it was deemed the predominant source of voluntary corporate disclosure to investors and was the single communication medium over which management had complete editorial control and was not subject to potential re-interpretations and distortions by the media.

Such attention has demonstrated how narrative reporting contained within annual reports is used as an impression management technique by preparers in securing a positive image of the entity (Stanton, Stanton & Pires 2004). These techniques typically use graphs (Beattie & Jones, 2000; 2001; 2002), variegated colours (Courtis 2004), human resource metrics (Abeysekera & Guthrie 2004) and intellectual capital information (Abeysekera & Guthrie 2005).

Traditionally, there are two parts to an annual report: a voluntary narrative section and a mandatory statutory financial statements’ section. The former section includes tables and graphs (Stanton et al. 2004) together with narratives of the chairperson’s/presidents’ statement, which may contain twice the quantity of information as that contained in statutory financial statements (Smith & Taffler 2000). The latter section is normally statutory bound.

Clatworthy and Jones (2001) claim that the abundance of information in the voluntary narrative section is due to the absence of any regulatory guidelines, Brown and Astami (2006), for example, found much of a Chairman’s Report was grounded in bombast and persiflage which was used to elevate a company’s performance.

This narrative section is claimed to contain useful information for decision-making by annual report users, such as financial analysts and investors (Barlett & Chandler 1997; IASB 2006; Tiexiera 2004) but has sometimes been criticised for its lack of qualitative characteristics (IASB 2006) and its overuse of stylised diction and tone (Brown & Astami 2006).

This paper examines the qualitative characteristics of narrative reporting as recommended by the IASB (2006) in the context of the management commentary section of New Zealand companies’ annual reports. The research question is expressed as follows:

RQ: To what extent do management commentary sections of New Zealand companies’ annual reports fulfil the qualitative characteristics of IASB’s (2006) guidelines?

Sources of legislation touching upon financial reporting by New Zealand companies include the Companies Act (1993) and accounting standards and requirements of the New Zealand Stock Exchange. Crucially disclosures in the management commentary section of New Zealand companies’ annual reports are not guided by any legislation.

This is an extremely timely and important study because corporate reporting standards in New Zealand are well recognised, and much time and resources have been devoted by New Zealand and Australian accounting standards setting bodies to align Australian and New Zealand accounting standards. The Trans-Tasman Standards Advisory Group, for example, is composed of members from the Financial Reporting Council (FRC), Australian Accounting Standards Board (AASB), the professional accounting bodies and officials from the Australian Treasury and the New Zealand Ministry of Economic Development (FRC 2010).
In recent times, the Group has attempted to present a protocol of co-operation between the New Zealand Financial Reporting Standards Board (FRSB) and AASB to be used when working through each standard. This protocol sets out processes issued in Australia and New Zealand in ensuring that Australia and New Zealand present similar positions at international forums. However, unlike Australia, there is no New Zealand Companies’ Act or New Zealand Financial Reporting Act requirement to disclose a director’s report. Brown, Taylor and Walter (1999) note that considerable criticism was leveled at the quality and frequency of Australian Stock Market enforced listing rules relating to the maintenance of an informed market. Thus, the results of this study, will be of interest not only to advisory groups of Trans-Tasman accounting cooperation but to those Australian and New Zealand practitioners, regulators and academics with an interest in the qualitative characteristics of narratives that are completely discretionary.

Prior Research- Narrative Disclosure

Prior research in the area of narrative reporting has concentrated on the use of graphs, status of reporting and reading ease of the narrative section of annual reports. These studies are discussed below.

Studies in the Area of the Status of Graphical Reporting in Narrative Sections of Annual Reports

Corporate graphical reporting in annual reports was investigated by Beattie and Jones (2000; 2001; 2002). The extent to which the front half of an annual report is used by management to provide a positive impression with the inclusion of financial graphs was analysed by Beattie and Jones (2002). The authors reported that, in some countries financial graphs were used selectively and displayed measurement distortion, and that the motivation behind providing such distorted graphs was to provide a more favourable view of financial performance than the actual one. Beattie and Jones (2002) also found that the accuracy of comparative judgements is affected by the graph slope.

A comparative study of graphical reporting practices of 50 companies from each of the six countries, that is, Australia, France, Germany, the Netherlands, the UK and the US was conducted by Beattie and Jones (2001). They investigated the existence of graphs, the existence of key performance variable (KPV) graphs, the topics graphed, the prominence of presentation and the length of time period graphed in each topic in their study. They found minute variation in the percentage of companies using graphs, while comparing between companies belonging to respective countries. KPVs such as sales, earnings, dividends per share, earnings per share, return on capital employed (ROCE) and cash flow were graphed by more than 25% of companies in each of these countries. Their results indicated topics graphed by these companies was related to their country of association. For example, only Dutch companies graphed cash flow, only U.S. companies graphed ROCE, while only German companies graphed sales. Their evidence suggests that graphical practices in the micro-based countries (Australia, the Netherlands, the U.K., and the U.S.) were notably different from those in the macro-based countries (France and Germany).

Some concern was raised by Beattie and Jones (2000; 2002) in regard to impression management with the use of graphs by companies in their annual reports. Beattie and Jones (2001) reported that there exist differences in graphical reporting practices of companies between countries. However, none of these studies included a comprehensive measure of qualitative characteristics of the corporate annual reports’ narrative section.
Studies in the Area of the Status of Narrative Reporting

Deloitte (2006) conducted a longitudinal survey from 1996 to 2006 of the narrative disclosure by 100 U.K. listed companies in their annual reports. The result was that the length of annual reports increased in this ten year period, that is, an average of 71 pages in 2005 and 85 pages in 2006 compared to 45 pages in 1996. More companies were reporting principal risks and uncertainties facing their entity in 2006 compared to 2005, that is, 74% compared to 54%. Their results also indicated an improvement in reporting about these companies non-financial information in 2006 compared to 2005 and 1996. Forward-looking information was reported sparingly, though it was improving.

The report by Deloitte (2006), which indicates that the lengths of companies’ annual reports are increasing, raises concern as to whether this additional information is increasingly satisfying investors’ required qualitative characteristics. Hence, our research concentrates on qualitative characteristics. The next section outlines previous research concentrating specifically on the management commentary section of annual reports.

Studies in the Area of the Extent of Reading Ease in Management Commentary Section of Annual Reports

Courtis and Hassen (2002) investigated whether differences in language of reporting affects the reading ease. The authors measured the readability levels by observing chairman’s address written in English and Chinese for a sample of 65 Hong Kong annual reports, and written in English and Malay for a sample of 53 Malaysian annual reports. Courtis and Hassen (2002) scored identical passages from the chairman’s address in both languages using Flesch and Yang formulas for Hong Kong, and Flesch and Yunus formulas for Malaysia respectively. They suggest, following their observation, that the indigenous language versions were easier to read than their corresponding English versions. Their evidence also indicated that the English passages in Malaysian annual reports were easier to read compared to those in Hong Kong annual reports. The authors suggest following their observation that transnational analysts and investors reading English versions experience diversity across jurisdictions.

Clatworthy and Jones (2001) surveyed the Chairman’s statement of 60 UK companies to investigate whether there was variability in these statements’ reading ease. They concluded that the introduction paragraphs of these chairman’s statements were easier to read than later paragraphs. The authors found no evidence that readability variability was used in these statements to suppress ‘bad news’. The variability in reading ease was determined by the theme of reporting in each paragraph of chairman’s statements. First passages in chairman’s statements were easier to read as they only discussed an overview of the business rather than technical discussions of financial results as in later paragraphs. As with Courtis and Hassen (2002), Clatworthy and Jones (2001) did not provide a comprehensive measure of qualitative characteristics of Charman’s statement.

Teixeira (2004) found management commentary can be incomplete and biased if it does not report ‘bad news’ together with ‘good news’. The author suggested that management commentary should describe the main business, together with operational and strategic factors facing an entity. A similar suggestion was provided by the IASB (2006), which states that to attain a higher quality ranking, management commentary should provide equal emphasis to good and bad news.

IASB (2006) provides a framework that outlines investors’ required qualitative characteristics in the management commentary section of annual reports. Following the dearth of literature examining or proposing a framework of qualitative characteristics in the