Disclosure And Performance: An Indian Evidence

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ARTICLE INFO	ABSTRACT
	This paper aims to examine the relationship between the readability of annual reports and corporate governance in Indian listed firms while controlling for firm's performance and specific features such as size, age and industry type. The current study uses both legitimacy theory and agency theory to create testable hypotheses. It tests for obfuscation in annual reports by investigating the relationship between the readability of narrative disclosures (NDs) and corporate governance from 2015 to 2019 using a sample of 82 firm-year listed companies on the Bombay Stock Exchange. The findings show that firms with low annual report readability are poorly governed which is an indication of the existence of "obfuscation." Indian firms may use narrative complexity as a disclosure strategy to enhance their image and consequently maintain their social legitimacy. Although the study findings suffer from limited global generalization, they can be generalized across Asian countries. Thus, future cross-country research is encouraged. The findings encourage India's policymakers to instate a policy for "Plain English" writing to make NDs easy to read by international investors. Present study is one of the very few studies that examines the readability of annual reports in emerging market economies, i.e. India. The study contributes to the paucity of research that examines English-written annual reports in non-English speaking countries. **Keywords** – Readability, agency theory, corporate governance, corporate performance, legitimacy theory

Introduction

This paper provides new evidence on the readability of accounting narrative information in the English language. As a novelty, we demonstrate the relationship between readability with respect to good corporate governance practices. This relationship constitutes the objectives of this study.

'Readability' and 'legibility' are intrinsic elements that have an impact on the ease and speed of reading a text. The first has to do with the style in which a message is written (basically the length of words and sentences). The second refers to visually engaging with the text (size, typeface, margins and spaces, among others). This study focuses on readability and adds to the growing literature currently investigating the language used in accounting disclosures (Asay, Libby, & Rennekamp, 2018; Bonsall, Leone, Miller, & Rennekamp, 2017; Li, 2008; Lim, Chalmers, & Hanlon, 2018; Lo, Ramos, & Rogo, 2017; Loughran & McDonald, 2014; Moreno & Casasola, 2016; Suárez Fernández, 2016).

As annual reports have expanded, the complexity of accounting narratives is being questioned more intensely. The complexity of the disclosures made by companies has led regulatory bodies to initiate projects to improve the readability (Lim et al., 2018) and to reduce the size of annual reports. Organisations such as the Securities and Exchange Commission (SEC, 1998) have proposed limiting the number of pages allowed in the reports based on factors such as the industry and the size of the company. They have also contemplated the use of readability indices, such as Fog's, to help improve the reading of financial documents (Loughran & McDonald, 2014). However, for these authors, interest should not be focused on the style of writing (readability), but on writing more concise documents. The concern of some regulatory bodies like the SEC about the length of documents and their readability leads us to analyse whether the quantity of text and the quantity of visual elements that define their extension really affect their readability, that is, if these two characteristics of the documents affect readability. One the one hand, the shorter texts are easier to read (Loughran & McDonald, 2014) and, on the other hand, graphic resources, which are also expanding, (Beattie & Jones, 1997; Havemo,

2018) serve to "support the information and reasoning presented in paragraphs of a narrative nature" (CNMV, 2013, p. 35), both affecting readabilities.

An important part of the research has focused on associating readability with the characteristics of the companies, mainly with financial performance (Asay et al., 2018; Bushee, Gow, & Taylor, 2018; Guay, Samuels, & Taylor, 2016; Li, 2008), and to a lesser extent with other characteristics such as corporate governance mechanisms (Cerbioni & Parbonetti, 2007; Ginesti, Drago, Macchioni, & Sannino, 2018; Suárez Fernández, 2016; Velte, 2018). However, in this study we focus on investigating whether good governance practices, contained in the unified code of good governance, explain the readability of accounting narratives, since good governance practices have become a tool that encourages companies to increase their transparency (Mallin, 2013). If so, transparency will be transmitted to accounting narratives, which will disclose complex information with more clarity, speed and simplicity (readability). Consequently, our proposal is that good governance practices, by positively influencing transparency, affect the communications made by companies and, therefore, the readability of the accounting narratives they provide.

In this context we present our work for the Indian case. The aim is to analyse the readability of non-financial information contained in Management Reports. In particular, we analyse whether the readability of text, that determine the extension of management reports, and compliance of good governance practices, included in the Annual Report. To this end, we have analysed a total of 410 annual reports of Indian listed companies during the period 2015–2019. we demonstrate that companies that follow a greater number of good governance practices are those that issue more readable information.

Our work makes several contributions. First, it extends knowledge about the readability of accounting narratives, their extension and companies' compliance with good governance practices, since we have not found any paper that relates these variables in the literature. The relationship with good governance practices is also analysed, since it is expected that transparency and therefore readability will be greater in those companies that comply with a greater number of good governance recommendations. Secondly, It is important to note that most papers that analyse readability have focused on documents written in English and in English speaking countries. In addition, it is important to remember that India is the non-English speaking country of the world. Third, it analyses the management report of Indian listed companies, a document that has not received the attention it deserves, in spite of the fact that it is a mandatory report for those companies and so adds value to the study.

Our results may be of interest to the regulatory bodies that issue standards that are concerned with improving the readability of financial reports, since they must consider that, according to our findings, this improvement depends on the readability contained in the reports and on whether or not companies comply with good governance practices. It may also interest those responsible for preparing financial information, as well as analysts and general users of this kind of information.

The remainder of the paper is organised as follows. We provide background and develop hypotheses in section 2. The methodology used and the research design are then discussed in section 3. In section 4, the main results are presented. The work ends with the conclusions reached in section 5.

Background and Hypotheses Development

As the accounting narratives disclosed by companies is expanding, the complexity of these documents is questioned. That is, "Because many investors are neither lawyers, accountants, nor investment bankers, we need to start writing disclosure documents in a language investor can understand . . . The legalese and jargon of the past must give way to everyday words that communicate complex information clearly . . . Brokers and investment advisers can make better recommendations to their clients if they can read and understand these documents quickly and easily" (SEC, 1998, p. 9). This has prompted the international financial reporting community to initiate projects on streamlining annual reports to improve their readability (Lim et al., 2018).

The usefulness of corporate disclosure depends on readability and understandability (Ajina, Laouiti, & Msolli, 2016).

Readability relates to the text's inherent capability of being read quickly and easily (Schroeder & Gibson, 1990). Readability formulas have been frequently used in the literature in several fields of knowledge. Their implementation is simple, quick and inexpensive (Courtis, 1987), as well as being passive, so reader participation is not required (Jones, 1997). Most formulas are based on two variables — the number of syllables per word (semantic variable) and the number of words per sentence (syntactic variable) — that predict how readable a text will be (Courtis, 1986). The first measures semantic difficulty and recognition speed, whereas the second measures the burden on short-term memory (Smith & Taffler, 1992). The resulting scores can be interpreted against a scale of difficulty (Jones, 1997), where for the Flesch Reading Ease Formula (FREF), for example, high scores indicate reading ease (or a low educational level required for reading) and low scores indicate reading difficulty (or a high educational level required for reading).

Some of the most widely used formulas in the literature — henceforth called indices — to analyse the readability of accounting narratives are the Flesch index (Flesch, 1948) and the Gunning Fog Index or Fog Index (Gunning, 1952). The results of research in this topic are quite similar, concluding that accounting documents can be classified as difficult or very difficult to read within this scale of difficulty (Clatworthy & Jones, 2001; Courtis, 1995; Dolphin & Wagley, 1977; Lewis, Parker, Pound, & Sutcliffe, 1986; Loughran & McDonald, 2014; Smith &

Taffler, 1992; Soper & Dolphin, 1964). Loughran & McDonald (2014) used the Fog index to measure the readability of 10-K filings, which they considered illegible. Despite the difficulty due to the use of technical business language, these authors pointed out that experienced readers of these types of documents are unlikely to consider them difficult to read.

Readability Evolution

The literature has also used these indices to analyse the evolution of the readability of accounting narratives over time. The most widespread conclusion, when working with small samples of companies, is that documents are becoming increasingly difficult to read (Courtis, 1995; Dolphin & Wagley, 1977; Jones, 1988; Lewis et al., 1986; Soper & Dolphin, 1964). However, when large samples of companies have been used in the analysis, the results are inconclusive. Li (2008) observed that annual reports after 1999 improved in readability until 2002, when they became even more difficult to read than before 1999. On the other hand, Loughran & McDonald (2014) found that readability was similar in the two periods analysed, from 1994 to 2002 and from 2003 to 2011. Suárez Fernández (2016) also found that readability was similar during the years 2007, 2008 and 2009. With this background of mixed evidence, we propose the first hypothesis:

H1: The readability of the narrative information contained in management reports does not change over time.
Loughran & McDonald (2014), who argued readability is defined as the ability to assimilate valuation relevant information. In a traditional approach based on readability indices, such as the Flesch index (Flesch, 1948) or the Fog index (Gunning, 1952), where readability is measured on the length of words and sentences, this is not so obvious, since those longer reports with short words and sentences will be more readable.

Readability and Good Governance Practices

In the current scenario of uncertainty and recent financial scandals, it is necessary to increase the transparency of the information published by companies in order to reduce information asymmetries. One of the principles of corporate governance established by the OCDE (2016) is the disclosure of information and transparency. This principle requires, among other information minimums, the disclosure of non-financial information, usually as an integral part of company's management report. In this sense, the readability of corporate disclosures is crucial to mitigate the information asymmetry and improve stakeholders' perception of the firm (Ginesti et al., 2018).

Previous literature has investigated the influence of various factors of corporate governance on the disclosure of information. Bravo & Reguera-Alvarado (2017) have documented a positive association between board independence and financial reporting quality. Yekini et al. (2015) indicate a statistically significant relationship between board independence and the quality of community disclosures. Liu & Zhang (2017) have demonstrated a positive correlation between state-owned shareholding ratio, number of directors, number of meetings of the supervisory board and proportion of managerial staff shareholding, and the level of disclosure of social responsibility information; while the share ratio of the largest shareholder has a negative correlation. Wang (2016) also concluded that corporate governance has a positive correlation to the value of disclosure of environmental information.

On the other hand, the literature has also focused on associating readability with the characteristics of companies, mainly financial performance (Asay et al., 2018; Bushee et al., 2018; Guay et al., 2016; Li, 2008), measured through several variables such as earnings persistence (Li, 2008; Lo et al., 2017), profitability (Dempsey, Harrison, Luchtenberg, & Seiler, 2012; Moreno & Casasola, 2016), or stock return volatility, analyst forecast dispersion and analyst earnings forecast accuracy (Loughran & McDonald, 2014; Bonsall et al., 2017). To a lesser extent, attempts have also been made to associate readability with other firm characteristics, such as corporate governance mechanisms (Cerbioni & Parbonetti, 2007; Ginesti et al., 2018; Suárez Fernández, 2016; Velte, 2018). However, we have not found empirical evidence that associates readability with compliance with good governance practices.

The good governance codes aim to provide solutions to the asymmetric information problems between managers and shareholders. Kaspereit et al. (2017) suggested that investors who operate in markets with asymmetric information are more interested in the actions of companies that achieve high levels of corporate governance. The good governance codes contain recommendations on good governance practices, which improve the effectiveness of companies in terms of corporate governance and increase their legitimacy before investors (Zattoni & Cuomo, 2008). For this, good governance practices are a tool that facilitates the creation of an environment of trust, transparency and accountability (Mallin, 2013; OCDE, 2016). In this sense, Pucheta-Martínez & Narro-Forés (2014) argued that good governance practices arise to improve business management with principles such as transparency, which translates into clearer and more reliable information, increasing stakeholder confidence. If so, transparency will be transmitted to accounting documents, which will become more readable, since good corporate governance practices try to avoid the opportunistic behaviour of managers, who are tempted to take advantage of information asymmetries with respect to stakeholders (Cuomo, Mallin, & Zattoni, 2016; Fama & Jensen, 1983). Therefore, we propose the last hypothesis:

H2: Companies that comply with a greater number of the recommendations of good governance practices issue more readable management reports.

Research Design and Methodology

Data

Our database contains the annual reports of listed firms on the Continuous Market of the Bombay Stock Exchange during the period 2015–2019. All companies belonging to the financial sector — namely banks, insurance companies and investment companies — were eliminated. The use of this first filter was justified by the special characteristics of these types of firms because the SEBI makes specific recommendations for them that are different from the general recommendations given for the other companies analysed in this paper. As a result, we have an unbalanced panel of 82 listed Indian companies with 410 observations of consolidated management reports for the period 2015–2019 (see Table 1).

Table 1 - Sample description

Step	Filter	No. of firms (2015 – 2019)
Initial sample	Total Indian listed companies – S&P BSE 100	100
First filter	Financial companies	(-16)
Second filter	Companies with missing observations	(-2)
Final sample		82

The data related to the dependent variable (readability) was collected from the annual reports, while those corresponding to compliance with good practices were taken from the annual corporate governance reports. Finally, the financial information corresponding to the rest of the control variables (firm characteristics) were obtained from the ACE EQUITY database.

Readability Analysis

As we anticipated, the indices most frequently used in the literature to analyse the readability of accounting documents have been the Flesch index (Flesch, 1948) and the Fog index (Gunning, 1952). As both indices are highly correlated, we initially chose the Gunning FOG index to make the estimates, due to its wider use.

The readability analysis of the reports was carried out in several steps. First, the consolidated annual accounts of all the companies were obtained for the years 2015–2019, to extract from them the consolidated management reports (410 in total) that were analysed. These documents were converted to text format for later text processing. Thus, each of the 410 management report fragments, text converted, were processed into the python to obtain the number of readability scores using FOG index.

Variable Measurements
Dependent Variable: Readability

The variable to be explained in our work was readability, measured by the FOG index (Gunning, 1959). This considers word length (number of syllables per word) and sentence length (number of words per sentence) to determine the reading ease or difficulty. The word factor measures semantic difficulty and recognition speed, while the sentence factor quantifies the burden on short-term memory (Adelberg, 1979; Smith & Taffler, 1992). This adaptation is justified because the FOG index is designed for English texts and its direct application to Indian annual reports is appropriate because Indian annual reports are in English language. The FOG index is calculated as follows:

FOG INDEX =

The lower end indicates a very easy to read text, typical of scientific texts, $0.4 \left[\left(\frac{words}{sentences} \right) + 100 \left(\frac{complex\ words}{words} \right) \right]$ and the upper end indicates a very difficult to read text. Table 2 illustrates the full scale for this index. Table 2 Readability scores and their Reading level by grade as adapted from Gunning (1959).

Table 2 – FOG INDEX & Education level

Fog Index	Reading level by grade

17	College graduate
16	College senior
15	College junior
14	College sophomore
13	College freshman
12	High school senior
11	High school junior
10	High school sophomore
9	High school freshman
8	Eighth grade
7	Seventh grade
6	Sixth grade

Independent Variables – Corporate Governance

Principal component analysis is a commonly used statistical method to reduce the number of predictor variables (i.e., corporate governance provisions) and determine variables that explain most of the variance (Larcker et al., 2007). Therefore, and in order to identify the underlying components of our CGI and determine which corporate governance provisions are associated with each component, we follow Black et al. (2017), Larcker et al. (2007) and Karpoff et al. (2016) by employing principal component analysis. We run the principal component analysis for each of 26 CG variables and we retained first factor with highest loading values.

We expected that companies that carry out a greater compliance with recommendations of corporate governance practices are those that issue more readable management reports.

Control Variables

These variables were performance, size, age and number of employees. Performance was measured as the return on assets, defined by the earnings before interest and taxes (EBIT) divided by total assets. Following previous studies that found a positive relationship between performance and readability (Ajina et al., 2016; Dempsey et al., 2012; Li, 2008; Subramanian, Insley, & Blackwell, 1993), we expected that companies with better profits would produce more readable reports so that stakeholders would be aware of their good performance.

Following Courtis (1995), Li (2008), Lo et al. (2017), Rutherford (2003), Smith et al. (2006) and Suárez Fernández (2013, 2016), the third control variable was company size. This variable was computed as the log of the average number of workers. Large companies have more complex operations to report and thus produce more complex narratives (Ajina et al., 2016; Jones, 1988; Li, 2008; Lim et al., 2018). We therefore expected that larger companies would issue less readable reports, so the relationship will be negative. However, large companies also have more resources to spend on producing clearer reports than small companies and, therefore, may produce more readable reports (Courtis, 1995; Drago, Ginesti, Pongelli, & Sciascia, 2018). Considering both approaches, we expected both negative and positive relationships depending on whether operational complexity or information clarity would prevail when companies prepared their management reports (Lo et al., 2017).

We used the age of the company as the third control variable, measured by the log of the age. Older companies have fewer information asymmetries and, therefore, less uncertainty in the elaboration of information owing to accumulated experience, so their reports may be simpler and more readable (Li, 2008). However, it is also true that older companies tend to be larger and have more complex operations, so they may produce more complicated reports that are therefore less readable. Consequently, we expected both positive and negative relationships, depending on whether information asymmetries or the complexity of operations determined the greater or lesser readability of management reports (Lo et al., 2017).

Table A1 of the appendix contains the descriptive statistics of all the variables used in our study (i.e., dependent, independent and control variables), both measured in scalar terms and dichotomised. Finally, we included sector and year dummies as control variables to measure the industry and temporary effects in all the proposed relationships.

Models and Methodology

The second objective of the research is to examine to what extent the compliance of good governance practices (H2) explains the readability of management reports. To do this, the good governance practices variable was incorporated into the proposed model:

$$FOG_{it} = α_o + β1CGI + β_2PERFORMANCE + β_3AGE + β_4EE + β_5SIZE$$

where FOG_{it} represents Gunning FOG index, CGI represents PCA index of governance practices of company i in year t, PERFORMANC represents ROA of company I in year t, AGE represents age of company I in the year t, EE represents No. of employees of company I in the year t and SIZE represents return on net worth of company i in the year t.

We estimated model using panel data methodology. The use of panel data estimations allows us to control for individual effects or unobserved heterogeneity. We controlled this heterogeneity in companies to avoid biased results by modelling it as individual effects, i. In particular, we used random effects models with the Ordinary Least Squares (LS) estimator.

Before beginning the analysis, we also ran several tests to choose the method of estimation. First, we ran the Breusch– Pagan test, to check that a panel data model would be preferable to a pool of data. Second, we ran the Hausman test to compare the Within Groups (WG) estimator in fixed effects and the FGLS estimator in random effects, under the null hypothesis that the difference in coefficients is not systematic. We cannot reject the null hypothesis, so the FGLS estimator in random effects is preferable because it is more efficient. Finally, we ran the Pesaran test of cross-sectional independence, the Wooldridge test for autocorrelation and the Wald test for group-wise heteroscedasticity. All models had no cross-sectional dependence and no autocorrelation but heteroscedasticity, so they accounted for heteroscedasticity in residual distribution.

Results

Table 3 illustrates the descriptive statistics and score distribution of the FOG index by year. As can be seen, the data indicate that the mean (median) moves between the values 17.03−18.33 (16.73−17.76). In addition, these mean and median values are relatively stable over the years analysed, according to the Friedman test, so hypothesis H1 is corroborated.

After verifying that there were no problems of multicollinearity between the independent and control variables, we studied the relationships proposed previously through the regression models. we incorporated FOG and governance index along with control variables in regression model (2). Table 4 illustrates the results of the regressions obtained for the FOG index with respect to governance index. The estimates were carried out through random effects.

Table 3 - Descriptive statistics and score distribution of Gunning Fog index by years

	2015	2016	2017	2018	2019
Mean	17.03	17.45	17.72	17.83	18.32
Median	16.73	17.52	17.11	17.02	17.76
Mode	18.85	12.41	14.69	18.15	15.06
Standard Deviation	3.71	3.52	4.48	3.32	4.60
Minimum	10.54	12.11	12.15	12.77	12.01
Maximum	28.7	32.19	40.95	30.13	41.97
N	76	79	81	79	82
Friedman test	4.595 (0.331)				

Table 4 – Regression analysis Dependent variable – FOG INDEX

Independent Variable	Predicted sign	Coefficient	pvalue
Corporate governance index	-	-0.132***	0.007

Performance	-	0.041**	0.001	
AGE	+/-	0.078***	0.000	
No. of employees	+/-	-0.489***	0.001	
Firm size	+/-	-0.0145***	0.000	
Intercept		1.468**	0.021	
Sector dummy	Yes			
Year dummy	Yes			
Observations/Groups	367/78			
Adj. R-Squared	0.338			
Wald test	44.05***(0.001)			
Rho (☐☐	0.1667			

The results in regression suggest that there is a negative and statistically significant relationship between the readability of annual reports and CGI. This means that issuing more difficult to read reports are issued by poorly governed companies. These results are in line with the approaches of Bonsall et al. (2017), Li (2008), and Loughran & McDonald (2014).

The main finding of this model (1) is that there is a relationship between good governance practices and readability, which is negative and statistically significant. Companies complying with a higher percentage of recommendations leads to the creation of an environment of greater trust and transparency (Mallin, 2013; OCDE, 2016). This greater transparency translates into clearer and more reliable information published by companies, including the management reports, which become more readable. In this way, compliance with good governance practices prevents the opportunistic behaviour of managers, who are tempted to take advantage of information asymmetries with respect to stakeholders (Cuomo, Mallin, & Zattoni, 2016). We can therefore conclude that companies following good corporate governance practices issue management reports that are easier to read. These results verify hypothesis H2.

Conclusion

In this paper, we have analysed the readability of narrative information contained within the annual reports of Indian listed companies on the Bombay stock Exchange during the period 2015−2019. Once we obtained the FOG index for each management report, we tried to determine whether readability changed over time and also examined whether there is a relationship between good governance practices and readability.

Our results indicate that readability was very stable during the years analysed, in line with Suárez Fernández (2016). There is a positive and significant relationship between good governance practices and readability, which reveals that companies that follow a greater number of corporate governance practices issue more readable management reports. Good corporate governance improves the transparency of accounting narratives (Mallin, 2013; OCDE, 2016), communicating complex information with more clarity, speed, and simplicity (i.e., reports are more readable). Finally, regarding the control variables, we found that better performed companies presented less readable annual reports, while those of large companies issued more readable reports.

This study could not only be interest for those responsible for preparing financial information and stakeholders, but also for regulatory bodies. At the present time, where accounting information is expanding and increasingly complex, this paper provides empirical evidence that supports the projects and recommendations issued by several international organisations to improve the readability. Finally, we propose, as a novelty, that compliance with good corporate governance practices improves the transparency of the accounting information, which translates into more readable reports.

Appendix

Table A1 - Summary statistics of variables

Variables	Mean	Std. Dev.	Min	Q₁	Median	Q₃	max	N
FOG	17.747	8.382	0.400	14.735	17.110	19.282	114.460	410
CGI	0.000	1	-2.315	-0.652	0.005	0.643	3.141	410

ROA	2.375	185.525	-3740	5.426	10.178	15.471	73.940	410
AGE	45.339	25.031	2	26	38	65.250	112	410
EE	27461.040	59575.440	0	4284	8901	23537	424285	410
Worth	23682.550	42277.700	-1.820	3703.857	9369.485	23682.55	405311	410

Table A2 - Correlation matrix

Variables	CGI	ROA	AGE	EE	WORTH
CGI	1.00				
ROA	0.055	1.00			
AGE	0.252***	-0.019	1.00		
EE	0.066	-0.057	0.081	1.00	
WORTH	0.042	0.847***	-0.012	0.003	1
VIF	1.083	2.800	1.083	1.019	2.898

Table A3 - Corporate governance index (CGI) – Principal component analysis

SR. NO.	CORPORATE GOVERNANCE VARIABLES	FACTOR LOADINGS
1	Directorships per director	-0.038
2	Memberships per director	0.067
3	Board Meetings occurrences	0.185
4	Attendance of director at AGM	0.086
5	Attendance of director at board meeting	0.006
6	Female Director	-0.129
7	Duality	-0.097
8	Foreign ownership	0.469
9	Independent Director	-0.070
10	Institutional shareholding	-0.169
11	Non-Executive Director	0.021
12	Promoter ownership	0.032
13	Independent Director in audit committee	0.577
14	Meetings of audit committee	0.194
15	Non-executive directors in audit committee	0.591
16	Size of audit committee	0.598
17	Chairperson of CSR Committee is independent director	0.351
18	Independent directors in CSR Committee	0.765
19	Meetings of CSR committee	0.303

20	Non-Executive director in CSR Committee	0.784
21	Size of CSR Committee	0.697
22	Chairperson of Stakeholder committee is independent director	0.260
23	Independent director in stakeholder committee	0.448
24	Meetings of Stakeholder committee	0.122
25	Non-Executive director in stakeholder committee	0.521
26	Size of stakeholder committee	0.462

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