

A Review of the Studies of Narrative Information in Corporate Annual Reports

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Abstract

The narrative information is an integral part of corporate annual reports (CAR) and offers complementary insights into the operations of the reporting company. In recent years, investors have come to realize that the narrative information in corporate annual reports should be worthy of special attention with the frequent occurrences of financial fraud cases. Researchers of accounting, finance, management and linguistics have increasingly focused their efforts on investigating the narrative information and it is now recognized that there is an urgent need to develop an interdisciplinary approach to the study of narratives in corporate annual reports. This paper responds to this call and conducts a review of the studies on the narrative information in the CAR, and we find that (a) most previous researches are one-dimensional, (b) systematic comparative and empirical studies are far from enough. Our findings contribute to a systematic understanding of the literature of narratives in the CAR and have useful implications for the relevant research and Business English (BE) pedagogy in the context of China.

Keywords: narrative information, corporate annual reports, review, Business English, interdisciplinary

1. Introduction

1.1 Introduce the Narrative Information in CAR

Information is the investor's most reliable tool to make investment decisions. The function of accounting narrative information in corporate annual reports (CAR) is to amplify quantified accounting information. Most accounting narratives in CARs are not subject to external auditing, which makes it easier for managers to manipulate the information disclosed therein. For example, the scope of auditors' opinion in the CAR is limited to the financial statements and the notes. At best, other narrative accounting information is only monitored by external auditors for consistency with the financial statements.

Narrative reporting information is usually defined as all the annual report content published by companies other than the financial statements, notes, and the auditor's report (Rowbottom, N., & Lymer, A., 2010). This definition of narrative reporting covers all language information that accompanies the financial statements. Financial information is frequently communicated through written narratives which are largely qualitative in nature and which are sometimes referred to as "soft" or unquantified information. Accounting narratives can be found in annual reports, as well as financial statements, accounting textbooks, official pronouncements by accounting bodies, and legal judgments concerning accounting issues (Jones, M.J. & Shoemaker, 1994).

According to the ASB (2006) narrative information reported in the OFR should *complement* as well as *supplement* the financial statements, to enhance the overall corporate disclosure which means that the narrative information should play either a complementary or supplementary role to the financial statements. Taurigana and Mangena (2006: 73) define

complementary narrative information as that information that refers to specific accounting numbers presented in the financial statements. The objective of such information is to inform the reader why such numbers are lower, the same or higher compared to the previous period. On the contrary, supplementary narrative information is defined as additional narrative information that does not refer to specific accounting numbers presented in financial statements. This includes non-specific narrative information on prospects, the reporting company's strategy, and the operating environment. The importance of supplementary information in assisting the investment decision process is also supported by many researchers (Wilson & Allison-Koerber, 1992; Milne & Chan, 1999). In this dissertation, the focus will be on the MD&A reporting in the annual reports from the publicly listed companies in the U.S.A. and China.

1.2 Describe the Narrative Disclosures in CAR

The narrative disclosures in the CAR include the Chairman's Letter, Auditor's Report, notes to the financial statements, and Management's Discussion and Analysis of financial condition and results of operation, commonly referred to as "MD&A", which is an integral part of the CAR (named as "Form 10-K" with SEC) and quarterly reports (named as "Form 10-Q" with SEC) filed with the Securities and Exchange Commission (SEC). MD&A can also be found in the registration statements filed under both the Securities Exchange Act of 1934 (Form 10) and the Securities Act of 1933 (Form S-1).

The CAR usually starts with an introduction and a Chairman's Letter, primary owner or the CEO of the company to the shareholders providing a snapshot of the significant developments in the past year, company initiatives and a summary of the financials. Key elements included in this section are the challenges that the business faced, its successes, and the prospective growth of the company.

An Auditor's Report is a written letter from the auditor containing their opinion on whether a company's financial statements comply with generally accepted accounting principles (GAAP) and are free from material misstatement. The independent and external audit report is typically published with the company's annual report. The auditor's report is important because banks and creditors require an audit of a company's financial statements before lending to them.

MD&A requires analyses and discussions from officers and directors of a company and, due to the many components of the required information, SEC reviews and comments are often generated. Item 303 of Regulation S-K clarifies the required information for MD&A. The discussion in MD&A for quarterly reports on Form 10-Q is abbreviated from the requirements for the CAR on Form 10-K and registration statements and should concentrate on updating and supplementing the annual report discussion. Although quarterly reports must discuss each item enumerated below, the discussion is expected to be more focused, concentrating on the most relevant and material items. The SEC in the U.S. issued detailed interpretive guidance concerning the narrative disclosures, which facilitates the understanding of the required content.

1.3 Explore the Importance of the Narrative information

The importance of narrative information to readers of CARs is discussed in the previous studies (Beattie, 1999; Rutherford, 2002; Beattie, McInnes & Fearnley, 2004). The researches in the U.K. (Lee & Tweedie, 1981; Bartlett & Chandler, 1997) show that narrative disclosures in CAR, including the Chairman's Letter, MD&A, and the notes to the financial statements, are widely used by both professional and non-professional stakeholders. Similar results are also found in the empirical researches in the U.S. and Canada. For example, Abrahamson and Amir (1996) found that information disclosed in the chairman's letter was useful in confirming firms with better than expected future business performances. Rodgers and Grant (1997) documented that the MD&A disclosure of the CAR provides a large proportion of information used by sell-side analysts in their reports, providing much more information than the financial statements. Thomas (1997: 47) investigated the president's letters to shareholders in a period of declining performance and realized that "as the news becomes more negative, linguistic structures suggest a factual, 'objective', the situation caused by circumstances not attributable to any persons who might otherwise be thought responsible". In addition, Clarkson, Kao and Richardson (1999) found that MD&A narratives of CARs offer a source of new and useful information to sell-side financial analysts and institutes, arguing that narrative information is significant to professional investors and institutes as well as nonprofessional investors. Similarly, Barron & Kile (1999) revealed that high-quality MD&A narratives and the dispersion in the analysts' earnings forecasts are closely related.

In a word, it is generally agreed that the narrative disclosure in the CAR is regarded as the crucial element in reaching the desired goal in the quality of financial reporting. As a major carrier of narrative information in the CAR, the narrative disclosure carries some importance accordingly and deserves more attention from researchers in the world.

2. Studies of the Narrative Information in the CAR

2.1 Approaches to studies of the narrative information

A variety of approaches have been adopted by different researchers to analyze the financial narratives in the CAR. Although focuses and perspectives vary across approaches, the ultimate objective of all the related studies is to improve the quality of narrative disclosure in the CAR and reveal the underlying motivation for the language use.

1) Subjective ratings

In the U.S.A., subjective ratings are first used to measure the disclosure quality of narrative information in the CAR. Many studies resort to the analyst scores of disclosure quality offered by the Association of Investment Management and Research (AIMR). The reports of subjective ratings provide an overall picture of corporate communications with stockholders. Usually, an average of 27 industries is included in each year, and an average of 17 companies is rated by 13 analysts in each industry. Annual published information, quarterly and other published information concerning investor relations are separately assessed. However, the disclosure rankings were discontinued in the U.S. in 1997.

Lang and Lundholm (1993) argue that the ratings measure the information level of disclosure informativeness". They acknowledge that the data are based on analysts' perceptions of disclosure rather than direct measures of actual disclosure. Healy and Palepu (2001: 34) criticize these rankings for three reasons: the lack of clarity as to whether the analysts on the panels take the ratings seriously, the unclear basis on which firms are selected for inclusion, and the potential biases that analysts bring to the ratings.

In the other countries, it is another case with the subjective rating. Publicly subjective ratings are not routinely available and so researchers have had to approach analysts directly for the needed information (Clarkson, Kao & Richardson, 1999). Later, a variant on the use of analyst ratings emerges in the form of SEC ratings of the CAR compliance, which is a measure is used by Barron, Kile and O'Keefe (1999).

2) Disclosure index

It is quite difficult to examine the disclosure quality directly, so some researchers propose the concept of disclosure index and it assumes that the amount of disclosure on specified topics reflects the quality of disclosure. Usually, they use a simple binary coding scheme, and the presence or absence of an item is recorded. Other coding schemes incorporate ordinal measures (often three levels), to allow for the 'quality' of the specific disclosure to be assessed. Generally, quantified disclosure scores 2, qualitative disclosure scores 1, and no disclosure scores 0. This is the approach adopted by Botosan (1997), who acknowledges that the disclosure quality is significant but quite difficult to check. Therefore, researchers tend to assume quantity and quality are positively related.

Robb, Single and Zarzeski (2001) carried out a topic-based analysis of non-financial disclosures in Australia, Canada, and the U.S. There the non-financial disclosure was defined as the qualitative information included in the CAR, excluding the four financial statements and related footnotes.

3) Theme-based counts

Jones and Shoemaker (1994) study the literature on the information of accounting narratives and they believe that the recording unit for most researches is "themes" (which can be longer or shorter than a sentence), and words are the next most common unit used in the studies.

Smith and Taffler (2000) from the U.K. count both the words and themes in the chairmen's letters and both word- and theme-based counts relate specifically to the forecast of financial distress. The authors try to set up a powerful model to forecast the corporate failure based on the frequencies of some specific words in the chairmen's letter, like *overdraft*, *loans*, *disposal*, etc.

In the U.K., Rutherford (2002) finishes a detailed line-by-line coding of the OFR texts from 10 listed U.K. companies, according to the topic categories in the ASB guidance (ASB, 1993). Just over half of all disclosures are found to cover either the operating result for the period (38%) or investment for the future (13%).

4) Readability

Jones and Shoemaker (1994) review 32 readability researches (26 of which address the narratives in the CAR). The readability test is designed to quantify the cognitive difficulty of texts and usually a readability formula, e.g. the Flesch index is adopted. Generally, the readability test is based on a statistic calculation of sentence length and word syllable count.

The computed score is compared to some benchmarks to assess the degree of reading difficulty of the text. It is generally agreed that narratives in the CAR are difficult or very difficult to comprehend. The readability of the financial narrative in the CAR can be an important index to decide the quality of narrative disclosure in the CAR.

5) Genre analysis

Most linguists approach the CAR as a genre. Swales (1990: 45-47) first regarded the CAR as a specific genre, which shows “a shared set of communicative purposes as the principle feature that turns a collection of communicative events into a genre”. Bhatia (1993, 2004) defines genres as organized, structured, communicative events, motivated by various communicative purposes and performed by specific discourse communities.

Rutherford (2005) claims that the Operating and Financial Review (OFR) is a genre of accounting narrative, employing word frequencies to identify genre rules. A corpus of 419 narratives from CARs is built to study lexical choices based on word frequencies of all the narratives combined. He believes that less successful companies tend to use words with positive connotations more often than successful companies (pp. 349-375). Evidence of rhetorical ploys within the genre and of differences in word frequencies is also found, which suggests the existence of subgenres, related to the rhetorical situation in the CAR. Evidence of subgenres includes the differential propensity to employ positive language and differences in the rhetorical ploys adopted concerning marketing strategy, corporate recovery, self-reference, comparative analysis, and gearing (leverage). This research also sheds light on the value of a corpus linguistics approach in analyzing accounting narratives.

6) Impression management

Impression management originates from social psychology, and then attracts the attention of researchers from different disciplines. In the study of narrative disclosure in the CAR, it refers to management’s attempts to manipulate the interpretation of disclosed data. Johnson, Rice and Roemmich (1980) first studied impression management in the CAR and they considered the issue of distortions in graph construction as a kind of impression management. They examined 50 CARs randomly selected from Fortune 500 companies in the U.S. These corporations included 423 graphs in their CARs over the period 1977-1978. Their findings suggested that at least one graph was incorrectly constructed in 42% of the CARs and 29.5% of all graphs reviewed were organized incorrectly.

Impression management in the CAR suggests that managers opportunistically take advantage of information asymmetries and use discretion in corporate narrative reporting by manipulating the presentation and disclosure of narrative information to “distort readers’ perceptions of corporate achievements” (Godfrey et al., 2003: 96). Just like the earnings management, impression management is taken as forming an inconsistency between the manager’s view of operational performance and the public view conveyed in corporate narrative disclosures (Healy & Wahlen, 1999: 368). Corporate narrative files are viewed to be potential vehicles for impression management and they can be used by the manager to present a self-biased view of corporate operational performance (Beattie & Jones, 2000; Clatworthy & Jones, 2006). Impression management covers emphasizing positive organizational results (enhancement) or obfuscating negative organizational performances (concealment), like by including more favorable earnings numbers in corporate narrative documents or by presenting positive organizational results more prominently than negative organizational results through positioning or highlighting. Negative organizational outcomes result in conflicts of interest between managers and stockholders, so managers are motivated to manipulate outsiders’ perceptions of the operational outcomes and the decisions made based on financial performance and prospects and engage in impression management (Aerts, 2005). Managerial motives mainly involve benefiting from increased compensation, especially via managerial stock options (Rutherford, 2003; Courtis, 2004).

Some impression management researches are explicit while some are implicit from the social psychology perspective. Impression management is regarded as a self-serving bias, and managers usually attribute the positive organizational results to internal factors and take responsibility for good performance but the negative organizational outcomes are attributed to the external factors and assign blame for bad performance (Clatworthy & Jones, 2003).

2.2 Studies of Financial Narratives in China

During the recent decades, many western scholars, most of who are from accounting and management disciplines, have conducted some analyses on the accounting narratives in different approaches. However, there are not many scholars in China who have studied the narrative sections in CARs, and even fewer of them have studied this specific genre from the perspective of corpus linguistics. On the contrary, much work has been done on the studies of financial statements and statistical information. The government regularly offers directions and guidelines for the drafting of the CAR, but the narrative sections are seldom touched upon in the regulations. The related studies of narrative disclosures in the CAR are mainly undertaken by two categories of researchers, namely accounting and linguistic ones.

2.2.1 Accounting Researchers' Efforts

In China, researchers from accounting background are trying to analyze the CAR of Chinese listed companies and explore the features of each section in the CAR. Wang Xiao (2002) reviewed the MD&A system in the United States and summarized the major features of MD&A and then offered some suggestions for China's narrative disclosure system. Sun Manli (2005) studied the CAR from the perspective of impression management. Ge Weiqi (2007) analyzed the readability of 40 sample annual reporting narratives randomly selected from both 2001 and 2005 annual reports (Chinese and English versions) of the companies listed in Shenzhen Stock Exchange.

2.2.2 Linguistics Researchers' Efforts

The development of study on the narrative information in CAR by linguistic researchers is rather limited in China, because not only the number of researches is small, but also the research scope is very limited. The previous studies of the narrative section in the CAR can fall into two types.

The first type focuses on the genre analysis of Chairman's Statement or CEO's Letter, trying to explore the linguistic or rhetoric features. And the second type extends the researches into the field of readability of the narrative disclosure in the CAR with the help of statistics or corpus linguistics.

Hu, C. & Tan, J. (2017) studied the culture-specific metaphors in Chinese letters to shareholders. The investigation of Letters to Shareholders (2006-2015) of the Industrial and Commercial Bank of China indicates that the culture-specific metaphors in these letters have ideational, interpersonal, and textual metafunctions. In the field of the functional grammatical system, Li H. & Zhao Y. (2008) carried out a research on the CAR in terms of functional grammar and found out the specific lexico-grammatical features and how these lexico-grammatical features realized its context Chairman's Statement in the CAR. Not many linguists are found in the research and studies of the narratives in the CAR. Some master candidates have tried to explore the language features in the CAR. For example, Wu Jie (2007) conducts a descriptive and explanatory study of 80 CARs downloaded from the SEC website. After analyzing the communicative purposes within the framework of the Swalesian School, she comes up with its generic structure along with the obligatory and optional moves in the CAR, adopting the qualitative analysis approach. Then, the function of each move is analyzed and the rationale behind it is specified. The strategy analysis adopts the quantitative analysis involving the Wordsmith 4.0 software package, and the analysis concentrates on the lexical strategy after investigating the information and rhetorical strategies applied in the reports. Shang Kun (2013), taking the classification of conjunctions by Halliday and Hasan and corpus linguistics as the theoretical framework, compares the conjunctions in the self-built corpus of the CAR and Brown Corpus employing quantitative and qualitative research methods to explore the features of usage. He mainly analyzes conjunctions in the following aspects: the overall frequencies, the frequently used conjunctions, the patterns and positions of some individual conjunctions and tries to discover the underlying causes of the differences. In terms of high-frequency conjunctions, the high-frequency conjunctions account for more than two-thirds of the total conjunctions used in annual reports. As for the individual conjunctions, *and*, *however*, *as a result (of)* and *previously* are the four most frequently used conjunctions in each category and they can be put either at the beginning or in the middle of the sentences. The Chi-square tested results reflect that there are significant differences in the frequencies of most conjunctions used in CARs and Brown Corpus. Finally, this paper also makes initial research on the archaic words and the implicit conjunction used in the CAR.

3. Discussion of the Previous Studies

3.1 Comments on the Studies

Based on the previous review, the present paper argues that the extant research of narrative disclosures in the CAR can be expanded in the following two aspects.

First, they are essentially one-dimensional researches, but narrative disclosure is a complex, multi-faceted concept. The focus is generally centered on classifying the topic to which the information item refers to and often only the presence or the absence of a specific disclosure on a given topic is discussed. In general, little consideration is given to the complex nature of the narrative disclosures in the CAR. Researchers of accounting, finance, management, and linguistics have increasingly focused their efforts on investigating the narrative information and it is now recognized that there is an urgent need to develop an interdisciplinary approach to the study of narratives in corporate annual reports. Therefore, it becomes increasingly clear from the review that an interdisciplinary approach should be taken to analyze the language used in the CAR, which is related to management, linguistics, accounting, and so on. It is urgently necessary to set up a comprehensive and hierarchical framework to look at the language used in the CAR.

Second, most extant studies are partial in some sense, either because they examine only the MD&A systems or because they merely focus on the MD&A disclosure in one country. According to the review, not many researchers have undertaken a detailed comparative study of the narrative content of the MD&A from an interdisciplinary perspective.

A review of the achievements in relevant research fields does show that very few researchers have undertaken the comparative studies of MD&A texts from the perspective of corpus linguistics. Especially, the interdisciplinary and comparative analyses of this specific discourse are far from enough. Last, very few researchers in China have attached sufficient importance to the study of narratives in the MD&A. Therefore, this study is to conduct empirical and comparative studies on the MD&A of listed companies to explore their differences in the light of corpus linguistics, to help the MD&A producers and users prepare and read the MD&A effectively and efficiently, and at the same time make some pedagogical contribution to ESP teaching and learning.

3.2 Implication for the Business English

After World War II, English became the major communication language among different countries due to the American dominance in the world economy (Ren, 2016). Similarly, in the academic field, western scholars began to conduct researches on BE at an early time. In China, we started to pay attention to BE only because of the increasing number of trade and economic activities after the policy of “Reform and Opening Up”. Accordingly, universities and colleges have also begun to admit students to study BE as a major. Because of the complexity of the research background, the definitions of BE from different scholars at home and abroad are divergent. BE is the product of the interaction process of business communication. BE carries the information of business theories and practice; without the information of business in the language, it cannot be called BE.

In China, the major of BE is getting increasingly popular among the students and colleges. Against this background, the Ministry of Education issued a document of guidelines to direct the development of BE education in China. The author tentatively proposes a Double-winged model for BE in China, enlightened by the requirements on BE education from the Ministry of Education.

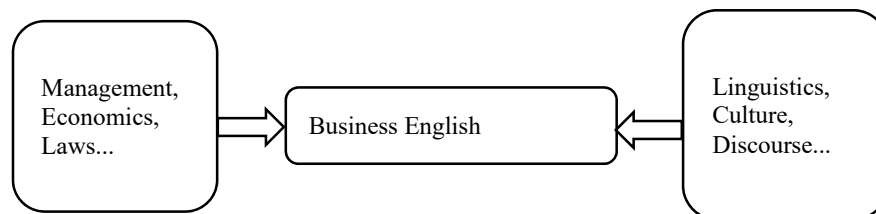


Figure 3.1 Business English Model (Double-wing Model)

Obviously, the linguistic competence is a necessity for BE majors. Besides the language courses, it is also important for the BE students to take courses concerning management and economics. With the double wings, the BE learners should fly high up in the sky of BE world.

4. Conclusion

CARs are widely read by various users for different purposes, and well-regulated or standardized reports with adequately arranged information exposition may be greatly beneficial to the users. However, the narrative information is currently less regulated than financial statements, and the management enjoys many more advantages on the narrative information than the other stakeholders. Previous studies are mainly carried out from a single perspective because most researchers are either linguists or accounting scholars or management researchers. Therefore, an integrated approach of linguistics, finance, and management will be of great significance.

Besides, the interdisciplinary analytical model for BE studies will be quite referential further studies. It could result in improvements in the studies of BE. And the results of the interdisciplinary investigation concerning different uses of linguistic resources across the different varieties of English narratives of CARs will be instructive for Chinese ESL/EFL writers and readers to compose and read the English narratives. The findings can also shed light on the teaching of BE

as an ESP (English for Special Purpose) in the Chinese context and narratives in CARs are useful and reliable first-hand resources for teaching and learning BE in China (Ren & Lu, 2021).

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