Voluntary Disclosure of Stock Performance in Management Reports: Italian Evidence

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Abstract

We explore financial information disclosure patterns of firms with high and low stock performance. In particular, the paper focuses on voluntary disclosure of stock performance in the Management report, the narrative section of annual report. We conducted an empirical analysis on a sample of Italian listed companies. We found that companies with high stock performance are more likely to voluntarily disclose this information. Thus, confirming that companies may select information to disclose in the framework of impression management.

Keywords: Management Report, Information disclosure, Stock performance disclosure, Italy.

1. Introduction

The purpose of this paper is to investigate the discretionary information decision in the narrative section of annual report, i.e. the Management Report (Management Discussion and Analysis in US; Operating and Financial Review in UK). We focus on managerial behavior in describing annual performance, namely, share return: voluntary disclosure in the narrative section of annual report. For this reason, we analyze the disclosure of stock performance in the Management Report. Previous research tried to emphasize different disclosure choices in firms with high and low financial performance (e.g. Clatworthy and Jones, 2006).We consider a different performance measure: stock price return. This approach is novel in literature, because previous scholars focused on performance stemming from the income statement rather than on stock returns in their investigations of a similar topic (see Section 2). However, as additional analysis, we rearrange our sample by considering the change of earnings before interest and taxes (Ebit) as indicator of profitability.

Annual reports contain quantitative and qualitative narrative information in order to help readers in their decisions. That explains why companies should "use plain language, only well defined technical terms, consistent terminology and an easy-to-follow structure" (Financial Reporting Council, 2009, p.48).According to general guidelines of IASB (2010), management should provide users with a comment and analysis of amounts presented in financial statements, specifically the entity's financial position, financial performance and cash flows. However, "management commentary should also include information about the entity and its performance that is not presented in financial statements but is important for management of the entity" (IASB, 2010: par. 16). While management is generally trying to explain a firm performance (presented in financial statements) in the narrative section of their annual reports, there is some space to analyze the performance not presented in financial statements. It is unknown, which set of variables drives voluntary disclosure specifically, so we explore the role of stock performance. We contributed by trying to analyze firms' disclosure patterns when they have high and low stock performance. We collected information about disclosure of stock performance. This type of information is not mandatory in the Italian context, so we offer an opportunity to eventually detect self-serving behavior, in disclosing and commenting stock performance. To this end, we observe if stock performance disclosure is different in group of companies with high and low stock performance. The theoretical framework we use refers to impression management in the preparer perspective (e.g., Merkl-Davis and Brennan, 2007).

Overall, we show that companies with better stock performance tend to disclose voluntarily this information. The implications of our research are mainly linked to policymakers on financial market: stock market authority should provide guidelines for a mandatory stock market performance disclosure in the management report. The paper continues as follows: literature survey and hypothesis development are included in the next Section 2. We present data and empirical design in Section 3 and main results in section 4. In the last Section we summarize our findings.

2. Literature review and hypothesis development

Prior studies emphasize the importance of discretionary narrative disclosures in the context of financial reporting environment. According to Beatty (2014, p. 112), "the literature on accounting narratives (European tradition) is related to the literature on voluntary disclosure (North American tradition). The different terminology (disclosure versus narrative) in part signals quite fundamental differences in researchers' philosophical beliefs, i.e. in the theories and methodologies that they use". However, to handle the narrative sections of corporate documents requires interdisciplinary borrowing; for instance, means of inquiry coming from other humanities and social sciences (literary theory, sociology, psychology, cultural studies, etc.) related to the communication process between a business entity and its environment. Some aspects of the language used in the narrative may be analyzed to evaluate the semantic (Haried, 1972) and the syntactic (Adelberg, 1979a) involved in business communication. The idea that managers may "obfuscate their failures and underscore their successes" in the narrative disclosures contained in financial reports was written in previous study, using readability procedure (Adelberg, 1979b). To test this obfuscation hypothesis and, in general, to analyze and evaluate the narrative of corporate documents may be a difficult task, that requires the adoptions of adequate methodologies (e.g. Beattie et al., 2004; Jones and Smith, 2014). For example, a lot of discussions are devoted to readability in its relation to performance measure of profitability. Previous scholars (Brennan et al., 2009) dedicated their research to assumption that firms with negative outcomes produce reports with low readability, which is called an impression management (Neu et al., 1998), obfuscation (Courtis, 1995) and incomplete revelation (Bloomfield, 2002).

In particular, text characteristics and firm performance relationship has been object of prior studies. For instance, Courtis (1986) does not find a strong correlation between readability and net profits and return on capital. Subramanian et al. (1993) analyzed 60 annual reports from two groups of profitable and unprofitable firms. They showed that the letter to stockholders of good performers were significantly easier to read than those of poor performers. Baker and Kare (1992) found a positive association between profitability and readability using the return on stockholders' equity, however, such association was missing when they used the net profit percentage as performance indicator. Smith and Taffler (1992), comparing failed and non-failed manufacturing companies, conclude that reading difficulty is associated with poor performance. Rutherford (2003) finds only limited evidence that poorly performing companies employ textual complexity to obfuscate in their accounting narratives. Clatworthy and Jones (2006) found evidence that the Chairman's statement of profitable companies is more likely to focus on specific key financial indicators.

Overall, we can state that the evidence found is mixed and inconclusive. The same simple mechanism of "emphasizing" good performance or "obfuscating" poor performance is also the background of a line of work that observe the use of graphs in annual reports. For example, Beattie and Jones (2000) find that companies are significantly more likely to include graphs of key financial variables when profit increases; Ianniello (2009) shows that graphical alterations that are favourable to the firms are relatively more frequent than those that are unfavourable.

These studies are examples of research that can be interpreted in a wider framework to explore if, how and why management may tend to measure, disclose and present annual reports in a favorable way. With the analogy between persons and organizations, one possible approach stems from the social psychology theory of "impression management" (e.g., Leary and Kowalski, 1990). It suggests that when people interact, they often attempt to manage the impressions that others form of them. This interpretative approach can be used in the corporate reporting studies: "Impression management can be viewed as the tendency for individuals or organisations to use data selectively so as to present themselves in a favourable light" (Clatworthy and Jones, 2006). Applying this understandable and simple psychological idea in the field of financial reporting may be misleading for some financial statement users. In particular, we are interested in narrative disclosure where impression management may be investigated in several ways.

Merkl-Davis and Brennan (2007) summarized seven impression management strategies that companies may deliberately or unconsciously use. Text features, namely, reading ease manipulation (readability) and persuasive language (rhetoric) may be used to obfuscate bad news. Among four strategies emphasizing good news, they mention the choice of benchmark and the selection of one of a number of earnings amounts for disclosure in order to favorably portray a current financial performance. The seventh strategy is the attribution of organizational outcomes that initially was explicitly adopted into a research design linked to social psychology literature, in particular to pattern defined as self-serving attributional bias (e.g., Aerts 2005).

It is arguable to frame the single disclosure of stock performance in the context of impression management since this decision does not involve a selection from a range of choice. However, this issue is a form of content analysis, characterized by disclosure index approach: in this case, one specified item is measured in simple binary term (presence/absence).

With the distinction described above regarding the voluntary disclosure of stock performance, our research can be framed in the field of studies that try to explain managerial disclosure strategies as opportunistic behavior, i.e. managers selectively disclose information for self-interest and manipulate the content and presentation of information in corporate documents with the purpose of distorting readers' perceptions of corporate performance and prospects or in other words, with the intent of managing the impression of outsiders readers of Management Report (e.g., Aerts, 2005; Brennan et al., 2009; Courtis, 2004; Godfrey et al., 2003).

Previous researches focusing on stock performance and information disclosure are rare and concentrated mainly in the Anglo-Saxon countries. For example, Lewellen et. al (1996) analyzed information about stock performance when it became mandatory to disclose it in corporate proxy statements in the US in 1993. They conclude that managers try to disclose their stock performances choosing a benchmark aiming to highlight positive performance and tending to obfuscate negative performance. Similar results are found in the case of Australia: Cassar (2001) shows that companies with better stock performance tend voluntary to disclose this information in their annual report in comparison with other companies. In the case of Italy, where disclosing information about stock performance is not mandatory, based on previous empirical evidence and the literature discussed above, we formulate the following hypothesis:

H1: Companies with better stock performance are more likely to voluntarily disclose share performance in their management report than those with poor stock performance.

3. Sample and Research Design

We start from stocks listed at stock exchange as reported by *BorsaItaliana Spa* (Italian Stock Exchange) at the end of the year 2013 (sample=290). First, we eliminate those included in AIM market (new sample=254), because we focus our analysis on standard security market (FTSE MIB), considering that from investors' perspectives, AIM and FTSE MIB are very different investible universe. Then, we double check our sample with regard to data feed process, by pooling Bloomberg and DataStream dataset and excluding overlapping stocks and stocks with not available data (new sample =166). We excluded bank, insurance and financial companies because we use accounting data in our empirical analysis that are not comparable with those of companies operating in other industries (new sample =128). This is due to the specific regulation and nature of business inherent to the financial sector. Moreover, we selected only companies with an accounting period ending on December 31, to keep temporal alignment between the management report and the annual calendar stock performance (new sample =122). Finally, we exclude foreign companies (new sample =112).From the remaining companies we selected the firms in the 1Q and the 4Q in terms of stock performance. This choice is in line with our research objectives to examine the extremes of stock performance; in this way, we may be able to detect the effects on stock performance disclosure. In sum, we collected the first best 28 stocks of Italian stock exchange, in terms of stock return in 2013, and we did the same for the worst 28 stocks. The sample size is in line with a number of previous studies (Clatworthy and Jones, 2003; Breton and Taffler, 2001; Brennan et al., 2009). The total sample of 56 firms represents 30.68% of the total market capitalization. For each company, we downloaded the management report included in the 2013 annual report available in each company's website.

To deepen our analysis, we challenge our results by selected additional tests, starting from the same overall sample, we made a new sort following a profitability index: yearly change in Ebit, that is increase or decrease of Ebit between 2013 and 2012. We rearranged both groups by including the best performer for Ebit criteria in the High cluster and the worst performer in the Low cluster. We replaced the stock performance with a profitability indicator (a yearly Ebit change) following previous studies (see Section 2) where a result stemming from the income statement is chosen as performance indicator.

Our empirical design is based in investigating stock performance disclosure in management reports of two clusters of firms: the best 28 (High28 group) and the worst 28 (Low28 group) stocks, listed in Italian equity general index (FTSEMIB), in terms of market performance in 2013. We selected this year, because we think it might have been the first year of recovery following the global financial crisis (e.g., Cukierman, 2013). For the purpose of our analysis, we manually gathered information on the presence or absence of voluntary disclosure about stock performance.

Daily observations of stock prices of listed companies belonging to Italian Stock index for the sample period of 02 January 2013- December 2013 were drawn from Bloomberg. We obtained yearly returns from daily observations by the use of the formula:

$$r_{i,t+1} = P_{i,t+1} / P_{i,t} \qquad\qquad (1)$$

4. Empiricalresults

Table 1 shows our sample of two groups of companies by stock performance in 2013 and Ebit change in the same year. We can observe that the cluster criteria corresponding to stock price change shows a statistical significance between the Best (Top) and the Worst (Low) stocks and a strong economic meaning corresponding to about 90% return in 2013. Observing the same sample, sorted in terms of Ebit change, we find a statistically significant difference between Top and Low group, where Top28 cluster shows a better performance (positive difference of about 9% increase in Ebit), confirming the goodness of sort criteria.

Table1–List of companies in the sample (N = 56)

This Table reports two groups of companies sorted by best 28 and worst 28 stock performance and Ebit change, listed in Italian Stock Market in 2013. Data are extracted from Bloomberg and DataStream. ***, **, * denote that estimates are statistically significant at the 1, 5 and 10% levels, performing Mean Pairwise Comparison test for two groups of companies.

LOW 28 GROUP	TOP 28 GROUP	LOW 28 GROUP	TOP 28 GROUP
Stock Return 2013		**Ebit change 2013**	
RCS Mediagroup	TXT E-Solutions	Mondo TV	Enel
Seat Pagine Gialle	Reply	Caleffi	Class Editori
Saipem	Safilo Group	A2A	Davide Campari Milano
Aedes	Cementir Holding	Stefanel	De'Longhi
Acotel Group	Snai	Tiscali	Safilo Group
Vincenzo Zucchi	FNM	Basicnet	Reply
Stefanel	Cairo Communications	Fiera di Milano	FNM
Alerion Cleanpower	La Doria	Pininfarina	La Doria
Eni	K.R. Energy	Eurotech	Fidia
Autostrade Meridionali	Sogefi	Italmobiliare	Isagro
Enel	Biesse	Cad It	Acea
Intek Group	Mediaset	K.R. Energy	Cementir Holding
Class Editori	Brembo	Telecom Italia	EI Towers
Cad It	IMA	Dmail Group	TXT E-Solutions
Caleffi	Dmail Group	Seat Pagine Gialle	Brembo
Telecom Italia	Italmobiliare	Saipem	Gruppo Ceramiche Ricchetti
Saes Getters	Reno De Medici	Alerion Cleanpower	Eni
Gruppo Ceramiche Ricchetti	Fiera di Milano	Aedes	Immsi
Fidia	A2A	Mediaset	Vincenzo Zucchi
Immsi	Ambienthesis	Saes Getters	Save
EL.EN.	Acea	Intek Group	Biesse
Davide Campari Milano	Save	Acotel Group	Sogefi
Tiscali	Engineering	Ambienthesis	Reno De Medici
Amplifon	Basicnet	Engineering	Autostrade Meridionali
Mondo TV	Acsm - Agam	Acsm - Agam	Vianini Lavori
Isagro	Vianini Lavori	Amplifon	Snai
De'Longhi	EI Towers	IMA	RCS Mediagroup
Pininfarina	Eurotech	Cairo Communications	EL.EN.

	Low28	Top28		Low28	Top28
Mean	0.04	0.90	Mean	-2.69	6.45
St. Dev	0.27	0.47	St. Dev	8.36	17.53
Difference	-0.86***		Difference	-9.14*	

In terms of disclosing stock performance, Table 2 shows that Top28 group of companies voluntarily choose to disclose this type of information at a higher level in comparison with the Low28 group of firms. In particular, using the Chi square test (two tailed) we have a statistically significant difference (N = 56, X = 8,928, p = 0,003), thus confirming H1.

Table2 - Differences between two groups of companies –Stock performance disclosure
This Table reports empirical results by performing Chi-square test for two groups of companies sorted by best 28 and worst 28 stock performance, and Ebit change listed in Italian Stock Market in 2013 according to respectively market financial return and income statement results. ***, **, * denote that estimates are statistically significant at the 1, 5 and 10% levels, performing Chi square test.

Stock performance disclosure – Stock return 2013			Stock performance disclosure – Ebitchange 2013		
	Low28	High28		Low28	High28
Count Yes	11	22	Count Yes	14	19
Count No	17	6	Count No	14	9
Total	28	28	Total	28	28
Count Yes – Count No	-6 ***	16 ***	Count Yes - Count No	0	10

4.1. Additional test

In addition to the previous analysis, we decided to change the criteria to group companies from stock returns to Ebit growth in 2013.Results are exhibited in Table 2. Regarding stock disclosure, we observe that the difference in the two groups of companies is not statistically significant using the Chi square test (two tailed, $N = 56$, $X = 1,845$, $p = 0,174$). This result was somehow expected as a consequence of changing the sorting criteria and give indirect robustness to the evidence confirming H1.

5. Conclusion

We updated the existing financial literature by focusing on voluntary disclosure of stock performance in the management report in the Italian context. This type of information is not mandatory in the Italian context, so we offer an opportunity to eventually detect self-serving behavior, in disclosing stock performance. For that purpose, we analyzed stock performance disclosure in two groups of companies with low and high stock performance. For the purpose of this research, a sample of 28 best and 28 worst Italian listed companies, in terms of stock performance,were analyzed. We show that companies with better stock performance voluntarily tend to disclose this information in their management report. Our evidence is in line with those of Lewellen et al. (1996) and Cassar (2001). Our H1 is supported confirming that companies may select information to disclose in the framework of impression management. Our findings might be useful for policy implications needed on financial market. Therefore, stock market authority should provide guidelines for a mandatory stock market performance disclosure in the management report.

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