Financial Disclosure Readability: Obfuscation and the Common Good

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Abstract
This study is focused on research related to textual information in corporate financial disclosures. Specifically, this paper establishes the foundation of current research covering the obfuscation hypothesis as it relates to financial disclosure readability manipulation. This study discusses how an emphasis on the common good may lead to more readable financial disclosures. Consequently, the common good perspective offers potential benefits to shareholders and the firm's broader stakeholder group. Knowledge gaps are highlighted and several promising directions for future research are provided. This study offers useful information for academics, financial regulators, accounting standard setters, preparers, and users of financial reporting.

INTRODUCTION AND BACKGROUND

Financial disclosure readability has consistently decreased over time (Dyer et al., 2017) and decreased disclosure readability hinders the free market economy (Bonsall & Miller, 2017; Chung et al., 2019; Hasan 2020; Miller, 2010). A supposed objective of financial accounting and reporting standards organizations, and financial regulators is the presentation of understandable and useful financial information (FASB, 2010; Framework, 2018; U.S. Securities and Exchange Commission, 1998 & 2016). Adelberg (1979) submits that the financial reporting process creates a circumstance in which managers may obfuscate their firm's deficiencies. This present study offers a review of the obfuscation literature and a discussion of how an emphasis on the common good may lead to more readable financial disclosures. Thus, a connection is drawn between the common good, improved market efficiency, and broader stakeholder benefits.

This study provides useful information for academics, financial regulators, accounting standard setters, preparers, and users of financial reporting. First, for academics, the results present a synthesis of findings and suggests paths for future research regarding the obfuscation hypothesis and a common good emphasis. Second, investors will benefit from this paper's collective insights by securing a better understanding of the existence and degree of strategic obfuscation. Third, individuals may be interested in seeing the relative futility of audits, regulation, and accounting standards. Fourth, readers will profit from reviewing the common good perspective as it relates to disclosure obfuscation. This article presents an argument that this perspective will decrease the amount of disclosure obfuscation.

The remainder of this report is organized as follows. section two (2) describes the obfuscation hypothesis. section three (3) presents the common good approach.

Section (4) presents the review methodology and scope. Section five through seven (5-7) cover the impact, antecedents, and potential antidotes related to strategic obfuscation via readability manipulation. A common good perspective is presented in each section. Section eight (8) provides the discussion and conclusion. Suggestions for future research are provided throughout the report.

OBFUSCATION HYPOTHESIS

The obfuscation hypothesis refers to the tendency of managers to purposely communicate bad news in a manner that is less readable than good news (Bloomfield, 2002; Courtis, 1998). Readers incur a higher opportunity cost when processing more complicated disclosures (Bai et al., 2019); therefore, obfuscation of negative information can lead to harmful decisions based on inadequate information processing (Patelli & Padrini, 2014). Empirical evidence suggests managers obfuscate financial narratives by creating longer documents (Henry, 2008; Humphreys, 2011) or using longer words and sentences (Courtis, 2004; Li, 2008; Asay 2018). Since markets react less completely to information that is less easily extracted from financial narratives, management has more incentive to obfuscate bad news (Bloomfield, 2002). The result is a purposeful barrier to free markets.

COMMON GOOD APPROACH

Modern ideas of the common good are traced to Aristotle and Thomas Aquinas. Aristotle's focus was on the city state, or polis, and his concept of common good relates to the eudaimonia (roughly translated as happiness) of its population (Finnis, 1998). Thomas contributed to the Aristotelian notion of common good. Thomists believe that the common good is the unifying factor of society (Sison & Fontrodona, 2012). Acquinas' (Finnis, 1998) view includes an appreciation of shared goals and an expression of how the common good can surpass the sum of individuals' good.

Adam Smith (2010b) suggests that individuals have an ingrained desire for the common good. Further, Smith (2010a) argues that the free-market system advances the common good by adding to society's overall wealth. "The common good neither implies nor requires comprehensive harmony" (Galson, 2013, p. 11). Competition is expected in the realm of mutually beneficial cooperation, and the common good reflects the result of bargaining for mutual advantage.

Arrow's impossibility theorem (1950) suggests a broader common good is unlikely. Though, smaller groups, such as a firm's stakeholders, provide a more suitable environment to practice the common good. The common good of a firm is the work in common that allows humans not only to produce goods and services but also to develop technically, intellectually, and ethically (Sison & Fontrodona, 2012). Therefore, a focus on common good may result in more competent disclosure authors that are interested in providing more readable disclosures. While activities focused on the common good promote broad stakeholder well-being (Argandoña, 1998), a firm's shareholders explicitly benefit from comprehensible financial disclosures shared by the firm's management.

METHOD AND SCOPE

An article search was performed for those covering disclosure obfuscation. References of the most pertinent articles were reviewed, which led to further resources. Studies were limited to those covering financial information written in English and produced in developed financial markets (S&P Global, 2018). This methodology resulted in the obfuscation-related articles examined in this present study.

IMPACT OF OBFUSCATION

Empirical Evidence

Regardless of management's motivation, managers and readers need to be aware of the disclosure readability's impact. Firms with difficult-to-read disclosure suffer from a variety of penalties. While Henry (2008) fails to find a significant relation between financial disclosure readability and equity price behavior, Biddle (2009) determines that less readable disclosures decrease capital market efficiency. Researchers express the results of this inefficiency as more uncertainty in analyst earnings' forecasts (Loughran & McDonald, 2014; Lehavy et al., 2011), equity price uncertainty, stock price declines, higher cost of equity (Biddle, 2009; Chung et al., 2019; Dempsey et al., 2012; Ertegrul et al., 2017), heightened risk of an equity price crash (Kim et al., 2019), lower values of cash holdings (Choi et al., 2021), and higher cost of debt (Bonsall & Miller, 2017; Chen & Tseng, 2020; Ertugrul et al., 2017).

Readers rely more on disclosures that are easier to process (Bai et al., 2019; Hemmings, 2020; Rennekamp, 2012). When investors' read more complex disclosures, their valuation judgments are more influenced by outside sources of information (Asay et al., 2017). Consequently, investors are less willing to trade in companies that publish less readable disclosures (Miller, 2010; Lawrence, 2013). Therefore, it is unsurprising that low disclosure readability is associated with higher cost of capital. Finally, firms with obfuscated disclosure are linked to higher incidence of shareholders' lawsuits (Abernathy et al., 2019), and higher audit fees (Abernathy et al., 2019; Xu et al., 2019).

Certain findings support the obfuscating manager's logic. For instance, when CEO pay is mildly excessive, a less readable compensation report is associated with diminished say-on-pay voting dissent (Hemmings et al., 2020; Hooghiemstra, et al., 2017). Further, Lee (2012) implies a link between unexpectedly poor readability and inefficient information processing by investors. Additionally, varying tone and reading ease simultaneously influences participants' perceptions of the firm (Tan et al. 2014 & 2015). The evidence suggests that a manager may choose personal gratification over benefits that accrue to a company (Bonsall & Miller, 2017).

It would be interesting to explore if a manager's disclosure readability level affects the managers future job prospects. Research is also necessary to investigate why differing aspects of disclosure obfuscation affect the firm's equity value. Regardless, the evidence suggests that firms and investors would benefit from more readable disclosures.

Common Good Perspective

A company's stakeholders comprise a local community. A firm's management and accounting professionals enhance the common good by providing clear, honest information to the stakeholder community. Further, prudent investing based on quality information adds to the overall good of society (Sison et al., 2018). Thus, a renewed focus on the common good may improve capital market efficiency while lowering a firm's cost of capital.

ANTECEDENTS OF OBFUSCATION

Empirical Evidence

Numerous studies lend support for the notion that managers attempt to hide bad news in less readable disclosures. Firms reporting losses (Dyer et al., 2017), lower earnings (Bakarich, 2019; Dempsey et al., 2012; Hasan, 2020; Henry, 2008; Lo et al., 2017; Merkley, 2014), lower earnings persistence (Li, 2008), and relatively high risks (Chakrabarty et al., 2018; Kim et al., 2019), including firms more likely to file bankruptcy (Kiwada & Wang, 2020), publish less readable disclosures. Results also suggest that companies that are being investigated for accounting fraud (Demaline, 2020), or that pay relatively high executive compensation (Laksmana et al., 2012) publish less readable disclosures. Asay et al. (2018) finds that authors draft bad news disclosures that are less readable than good news disclosure, and that difference is exacerbated by incentive compensation. Taken together, the evidence suggest that managers strategically manipulate bad news disclosure. Further study is necessary to determine how and why management characteristics and the firm's financial reporting quality combine to effect disclosure obfuscation.

Common Good Perspective

A common good perspective reminds managers and accountants that truth is an objective "good" that improves society (Finnis, 1980). Obfuscation antecedents such as lower earnings and higher risks need to be communicated transparently. Managers focused on the common good realize that their own compensation is not a higher priority than the good of all in the firm's community. Management and accounting based the common good principle will enhance the public interest contribution of financial narratives.

ANTIDOTES FOR OBFUSCATION

Empirical Evidence

Financial disclosure readability has decreased significantly over time (Dyer et al., 2017). Considering the amount of research dedicated to the causes of disclosure complexity, there has been relatively little work addressing the potential cures. A few factors relate to more readable narratives. Proper internal governance may mitigate strategic obfuscation (Aerts & Yan, 2017; Laksmana et al., 2012; Nadeem, 2021).

Even with improvements in corporate governance, management may still use opportunistic word crafting (Courtis, 2004; Hooghiemstra, 2017). External governance mechanisms fail to improve obfuscatory writing practices (Kim et al., 2019). Further, corporate governance constraints imposed by legislation may account for less readable disclosures (Dempsey et al., 2012).

Disclosure consistent with the SEC's plain English guidance (1998) may produce individual sentences that are easier to read (Bonsall & Miller, 2017; Nguyen & Kimura, 2020), but aggregate 10-K reading complexity, measured as the of total word count, increased since the plain English guidance was initiated (Nguyen & Kimura, 2020). Much of the increase in disclosure is required to comply with new SEC and Accounting Standards (Dyer et al., 2017; Lang & Stice-Lawrence, 2015). Fear of regulatory enforcement may instigate managers to inundate readers with trivial information (Henry, 2008). Further, managers may pursue obfuscatory behavior with the guise of regulatory compliance. Indeed, Dyer et al., (2017) finds no evidence to suggest that obfuscation is curtailed by litigation risk or regulatory factors. Further, managers may use textual obfuscation and earnings management as complementary tools for hiding bad news, particularly when earnings manipulation is under more regulatory scrutiny (Kim et al., 2019). Ultimately, regulators define what needs to be disclosed, the composition of those narratives are left to managerial discretion (Henry, 2008).

Audit quality (i.e., Big-N vs. other audit firms) has a negligible effect on disclosure readability manipulation (Lang & Stice-Lawrence, 2015; Lin et al., 2019). Indeed, evidence suggests that Big-N clients release less readable disclosures (Nelson & Pritchard, 2014). Interestingly, firms with less readable reports are associated with higher audit fees and increased risk of future accounting-related litigation (Abernathy, 2019). Auditors may be charging a premium in exchange for certifying less transparent disclosures. Perhaps investors perceive this arrangement since firms with less readable disclosure incur a higher cost of capital and the audit quality has no moderating effect on this relationship (Chen & Tseng, 2020; Courtis, 2004). It is unknown to what extent auditors are colluding with their clients. This area needs to be researched further.

A few studies legitimately indicate that strategic obfuscation can be curbed. Managers of firms with more conservative accounting policies are less prone to obfuscate disclosures (Kim et al., 2019). Locating firms in regions with high social capital (i.e., altruistic norms and networks that promote honest behavior) and hiring older and more skilled CEOs may result in less obfuscation (Courtis, 2004; Jha, 2019; Hasan, 2018; Xu et al., 2018; Xu et al., 2020). Further, Nadeem (2021) finds that board gender diversity is associated with more readable financial narratives.

Interestingly, disclosure readability improves if the news is calamitous. Firm disclosure shows short-term improvement after a "life-threatening" event such as receiving a going-concern opinion (Kawada & Wang, 2019), or surviving a major economic downturn (Patelli & Padrini; 2014). In summary, proper training and appropriate peer influence may be the antidote. Otherwise, the threat of impending doom make keep managers temporarily honest.

More research is required to explore factors that decrease strategic obfuscation. Future work may determine to what extent ethical climate may mitigate management's self-interested disclosure practices. More work is needed to determine the efficacy of various governance mechanisms as is relates to disclosure obfuscation. Finally, there is paucity of analysis on the collective role of individuals (e.g., attorneys, accountants, editors, managers) in the production of obfuscated disclosures. Survey research and individual interviews may inform the discussion on this topic. Researchers may consider the role that the competing motivations of these authors play in readability manipulation. This work may also involve an experimental research design—a design that has been minimally used to assess the obfuscation hypothesis.

Common Good Perspective

Evidence suggests that legislation and governance have a limited mitigating effect on

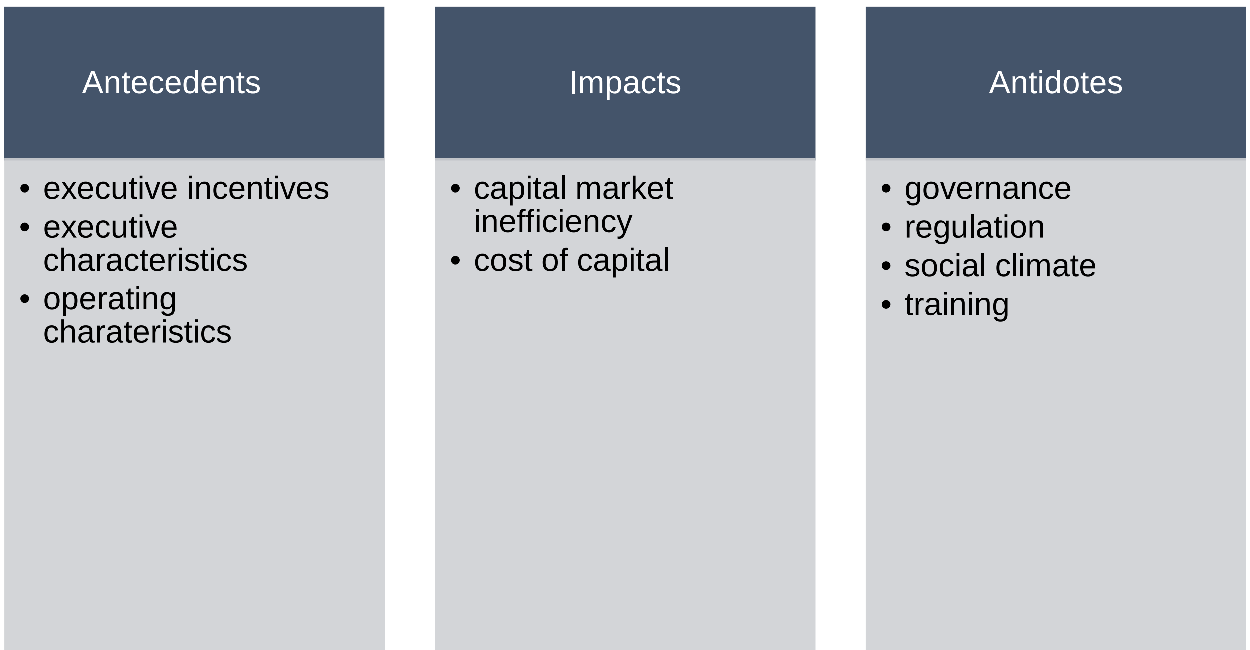

Figure 1. Notable attributes associated with disclosure obfuscation

strategic obfuscation. Though, adequate training and a positive social climate are beneficial antidotes. Further, gender diverse boards play a mitigating role by sharing a broader view of the firm's desired outcomes. Ultimately, legislators, board members, accounting professionals, and managers focused on the common good will improve the efficacy of regulation, governance, and training. Overall, this change in perspective will improve the social climate as well. Management and accounting from a common good perspective may mitigate obfuscation. Though, further research is needed to determine the oversight and training necessary to optimize the common good among firm stakeholders. Figure 1 summarizes the proposed antecedents, impacts, and antidotes.

DISCUSSION AND CONCLUSION

Adelberg (1979) notes that capital markets may be efficient to the extent of being able to see through obfuscation in financial reports. Disclosure complexity is a central and ongoing concern of financial reporting regulators, accounting standards setters, investors, and academics (Higgins, 2014; U.S. Securities and Exchange Commission, 1998 & 2016). This present study discussed the evolution of the obfuscation hypothesis and provided the focus and a critique of the strategic obfuscation literature[1]. Collectively, the research supports the notion that obfuscation is present in financial disclosures. The research shares a variety of impacts, antecedents, and mitigation techniques related to obfuscation. This present study suggests that a focus on the common good may result in more readable financial disclosures.

Avenues for future research have been provided. Addressing these questions will help contribute to a better understanding of managers strategic obfuscation. Further research is also necessary to determine how to focus managers and accounting professionals on the common good.

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[1] A summary of key findings in provided in the Appendix

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Appendix
SUMMARY OF NOTABLE OBFUSCATION RESEARCH

Study	Key Findings
Li, (2008)	Firms with 10-Ks that are more readable have more persistent positive earnings.
Laksmana et al. (2012)	Firms with relatively high CEO compensation have less readable CD&As in the 2007 proxy season but not in the 2008 proxy season.
Merkley (2014)	The relation between readability and operating performance depends on the disclosure topic.
Lang and Stice-Lawrence (2015)	More profitable firms are positively related to more readable disclosures.
Nelson and Pritchard (2016)	Before risk factors were mandated, firms with more litigation exposure released more understandable risk narratives.
Aertz and Yan (2017)	Rhetorical devices may add transparency to disclosures at the detriment of readability or increase readability without increasing transparency.
Lo et al. (2017)	MD&A readability is inversely related to the likelihood of earnings management.
Chakrabarty et al. (2018)	CEO vega is inversely related to financial disclosure readability.
Wang et al. (2018)	There is a positive relationship between a firm's CSR performance and the readability of the company's CSR reports.
Xu et al. (2018)	Older CEOs release more readable MD&As.