Audit Quality and Readability of the Annual Reports

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ABSTRACT

The purpose of this article is to examine the effects of audit quality, as proxied by Big 4 auditors and industry specialization, on the readability of the annual reports. Assuming that higher audit quality is associated with better readability, the authors empirically test whether (1) the readability enhances if audited by the Big 4 auditor and (2) the readability enhances if audited by the industry-specialized auditor. The authors find that the firms audited by Big 4 firms have less readable annual reports. The industry specialization does not affect readability, though Big 4 industry specialists are positively associated with less readable annual reports. The results also indicate that longitudinally the annual reports are becoming less readable, and the determinants of readability of the annual reports are changing and evolving, as our results differ from Li (2008)’s study. The authors believe that in the opposing forces of plain English movement and evolving and changing financial environment, certainly, the latter is winning.

KEYWORDS

Audit Quality, Readability Of The Annual Reports, Plain English Reporting

1. INTRODUCTION

Investors, analysts, and other stakeholders extensively rely on information provided in the annual reports. The clarity, transparency, and understandability of annual reports and 10-Ks have increasingly become a topic of interest for regulators, auditors, and investors (Li, 2010). SEC had taken an initiative to encourage the use of plain English and issued the earliest guidelines in 1998.1 This initiative has continued to evolve (Loughran and McDonald, 2014b). Concurrently, the disclosure requirements have significantly increased due to changes in the reporting regulations, emergence of complex financial transactions and instruments, and advancements in technology, resulting in less readable annual reports. Additionally, managerial incentives play an important role in structuring the annual reports (Bloomfield, 2008), which adds another dimension to the debate on the readability of the annual reports.

Measuring readability is inherently difficult due to the nature of the subject matter, intended audience, and the preparer’s intentions. The interdisciplinary research in the readability of the corporate annual reports started in the 1950s and continues until today. The earliest studies have used measures such as Flesch scale (Pashalian and Crissy, 1950; Soper and Dolphin, 1964), Dale-Chall readability formula (Smith and Smith, 1971), and Fog index (Parker, 1982; Cassell, 2019). The recent accounting studies have mainly used Fog index as a measure of readability (for example, Li, 2008; Biddle, Giles, & Rodrigo, 2009; Miller, 2010; Lehavy, Li, & Merkley, 2011; Lawrence, 2013; Inger et al., 2018). Bonsall et al. (2017) use Bog index as a measure of readability in narrative disclosures on

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bond ratings. Loughran and McDonald (2014a) demonstrate that the Fog index is not an appropriate measure of readability for the financial documents. Instead, they present a 10-K document file size as a proxy for readability measure that outperforms Fog index. Compared to the Fog index, file size is easier to measure and can be readily verified.

The previous accounting studies in the readability of the annual reports have not examined the relationship between audit quality and readability. The authors address this gap by examining the association between audit quality and readability of the annual reports. Specifically, the purpose of this paper is to examine the effects of audit quality, as proxied by Big 4 auditors and industry specialization, on the readability of the annual reports. Assuming that higher audit quality is associated with the better readability, the authors empirically test whether (1) the readability enhances if audited by the Big 4 auditor and (2) the readability enhances if audited by the industry specialized auditor.

Based on Loughran and McDonald (2014a) study, the authors use file size of 10-K documents as a proxy for readability in this paper. Audit quality has been defined and operationalized in numerous ways in the audit literature (Watkins, Hillison, & Morecroft, 2004; Francis, 2011; DeFond and Zang, 2014). The authors use Titman and Trueman (1986) definition of high-quality audit as an audit that improves the reliability of financial statement information and allows investors to make a more precise estimate of the firm’s value. This definition encompasses numbers as well as text included in the financial statements; readability of the financial statements can certainly aid investors in valuing the company.

The authors operationalize audit quality using audit size, that is, Big 4 versus non-Big 4 auditors, and the degree of industry specialization by the auditors. Francis (2004), Francis (2011), and DeFond and Zang (2014) analyze the studies that examined the association between Big N auditors and audit quality. The authors conclude that the literature overwhelmingly supports that Big N auditors deliver high-quality audits. Also, Francis (2004) and DeFond and Zang (2014) report that the majority of the previous research findings supports that industry specialization is positively associated with audit quality.

Our results add to the literature in the following ways. First, the annual reports are becoming more information-intensive and complex over the years resulting in less readable annual reports. Second, the determinants of readability of the annual reports are changing and evolving, as our results differ from Li (2008)’s study. Third, the firms audited by Big 4 firms have less readable annual reports. The industry specialization does not affect readability, though Big 4 industry specialists are positively associated with less readable annual reports. The authors believe that in the opposing forces of plain English movement and evolving and changing financial environment, certainly, the latter is winning. Finally, longer audit tenure is positively associated with complex, less readable annual reports. The authors also discuss policy implications for the SEC’s plain English initiative.

The rest of the paper is organized as follows. The second section contains the literature review and hypotheses development. The third section discusses the research design and variable measurement. This section also contains sample details, descriptive statistics, and empirical results. Finally, the authors provide conclusions in the fourth section.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

The primary purpose of accounting is generating and communicating financial information. Consequently, readability of the annual reports has been a topic of perennial interest. The interdisciplinary research in the readability of corporate annual reports started in the 1950s and continues until today. The authors review the research, first, to list the measures used for readability and, second, the results.

The earliest studies have used measures such as Flesch scale (Pashalian and Crissy, 1950; Soper and Dolphin, 1964), Dale-Chall readability formula (Smith and Smith, 1971), and Fog index (Parker, 1982). Courtis (1986) used Fry, Smog, Lix, and Rix measures to analyze the readability of
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