Readability of annual reports affects accuracy of analyst forecasts

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(PhysOrg.com) -- Stock analysts' earnings forecasts for companies with hard-to-read annual financial reports are more informative, but less accurate, say University of Michigan researchers.

A new journal article in the May issue of *Accounting Review* shows that sell-side financial analysts expend greater effort to generate earnings forecasts of publicly traded firms with less readable 10-K filings. This increased effort by analysts results in earnings reports to investors that contain more information—but less accuracy and greater uncertainty.

Required annually by the SEC, 10-K reports provide a comprehensive overview of a company's business and financial condition and include audited financial statements.

"Given the difficulty of following firms with less readable disclosures, analysts who choose to follow these firms likely exert greater effort to do so," said Reuven Lehavy, associate professor of accounting and the Michael and Joan Sakkinen Accounting Scholar at Michigan's Ross School of Business. "On the one hand, lower readability of firm financial disclosures can increase the cost of processing the information in these disclosures and, therefore, can increase the demand for analyst services.

"On the other hand, less readable disclosure can increase the costs of analyst coverage. That is, analysts bear greater information-processing costs and higher private search costs for this information, which can lead to less accurate forecasts."

Lehavy and Ross School colleagues Feng Li and Kenneth Merkley measured the readability of more than 33,700 observations of 10-K filings from 1995 to 2006. Using the Fog Index developed by the computational linguistics literature, they were able to determine the written complexity of 10-K reports by counting the number of syllables per word and number of complex words per sentence.

Through statistical analysis, the researchers found that more financial analysts follow firms with less readable 10-K reports (which suggests a greater demand for analyst reports for these firms); these analysts take, on average, two days longer to issue a first forecast revision following a 10-K filing (which suggests more effort put forth by them); and provide earnings forecasts that result in proportionally higher firm returns associated with their reports (which suggests that investors find these analysts' reports more informative).

However, the study shows that analyst earnings forecasts for companies with less readable 10-K reports have greater dispersion, are less accurate and are associated with greater overall analyst uncertainty.

"If less readable communication increases analysts' cost to process and interpret the information, then it is likely to lead to a more diverse set of interpretations about firm disclosures, resulting in higher analyst forecast dispersion," said Li, the Ernst & Young Assistant Professor of Accounting at the Ross School. "In addition, if less readable communication makes it more difficult to forecast earnings, then the accuracy of the analyst consensus forecast will be lower."

Overall, the researchers say their study suggests that analyst behavior is related to the readability of firms' communication.

"Our results are consistent with the prediction of increasing demand for analyst services for firms with less readable communication and a greater collective effort by analysts for firms with less readable disclosures," Lehavy said. "The evidence is relevant to the SEC's debate about the intended audience of financial information and the SEC's concerns on the accessibility of these reports."

Provided by University of Michigan