Two editing tricks can help companies boost investor confidence

September 10 2024, by Matt Shipman

Credit: CC0 Public Domain

A new study finds there are two simple editing changes companies can make to their annual reports that improve investor confidence.

At issue are so-called "material weaknesses in internal control." Internal controls are practices that prevent companies from inadvertently misrepresenting any aspect of their finances in their public-facing financial statements. Material weaknesses in internal controls refer to any problems that make the internal control system less effective.

"Material weaknesses in internal controls are bad news for investors, who rely on financial statements to make investment decisions," says Joe Brazel, co-author of a paper on the work and Jenkins Distinguished Professor of Accounting in North Carolina State University's Poole College of Management.

"That's why the Sarbanes-Oxley Act requires companies to disclose the effectiveness of their internal controls. For this study, we wanted to see if the language companies use when making those disclosures has an effect on how investors respond."

"Specifically, we wanted to look at two things," Brazel says. "First, how do investors respond when companies are defensive when disclosing material weaknesses, compared to taking more accountability for the weaknesses? Second, how do investors respond when companies use first-person pronouns when discussing material weaknesses, as opposed to referring specifically to management?"

For the study, the researchers first analyzed 200 internal control reports from publicly traded companies to assess the language they used when disclosing material weaknesses. This allowed the researchers to determine which communications approaches were most common. The researchers then enlisted 96 MBA students to serve as investors for an experiment designed to assess how investors respond to various communication approaches.

The researchers found that the most common approach among publicly traded companies was to use defensive language in conjunction with first-person pronouns.

"What's striking is that this is the exact opposite of what our experiment found to be the most effective communication approach," Brazel says.

The experiment found that nonprofessional investors are more willing to invest in a company when management doesn't use first-person pronouns and takes a less defensive position.

"Study participants responded better to internal control reports that said management is aware of the limitations that internal controls have and are developing safeguards to reduce those limitations," Brazel says.

"Prior communications research tells us that being defensive when conveying bad news can actually exacerbate the negative response in stakeholders," says Brazel. "And by using first person pronouns—we, us, our—more of the blame is placed on management.

"On the other hand, being less defensive improves the stakeholder response. And—perhaps ironically—explicitly referencing management, rather than using first-person pronouns, limits the extent to which any negative response is associated with the managers.

"The takeaway here is that the words we use matter a great deal," says Brazel. "And given that we're talking about how reports are phrased, this is a very low-cost intervention that companies can use to improve investor confidence."

The paper, "Management's Communication Style when Disclosing Material Weaknesses in Internal Control," is published in the journal *Accounting Horizons*.

More information: Joseph F. Brazel et al, Management's Communication Style When Disclosing Material Weaknesses in Internal Control, *Accounting Horizons* (2024). [DOI: 10.2308/HORIZONS-2023-007](https://dx.doi.org/10.2308/HORIZONS-2023-007)

Provided by North Carolina State University

Citation: Two editing tricks can help companies boost investor confidence (2024, September 10) retrieved 11 September 2024 from https://phys.org/news/2024-09-companies-boost-investor-confidence.html