
The chairman's statements and annual reports: Are they reporting the same company performance to investors?

ABSTRACT

This paper analyses the chairman's statements of the top 50 and bottom 50 companies listed on the JSE ranked by percentage change in profit before taxation. The research examines whether companies with improving and declining performance report good and bad news in different ways. The findings are in line with expectations and both groups of companies show a preference to emphasise the positive aspects of their performance. Furthermore, both groups prefer to take credit for good news themselves, while blaming the external environment for bad news. Managers use accounting narratives in a self-serving manner, rather than reporting performance objectively. The research in this paper has implications for the current state of financial reporting whereby auditors do not formally audit but instead review the chairman's statement to ascertain its consistency with the financial statements.

1. INTRODUCTION

Accounting narratives are becoming increasingly important in external reporting. These narratives, such as the chairman's report in South Africa, typically occupy prime position within the annual report and provide information beyond that required for statutory financial reporting. Such changes reinforce the evolution of the annual report from a statutorily-produced document into one in which narratives, photographs and graphs dominate. Empirical research in the US has demonstrated that both the inclusion and content of president's letters significantly affect the judgements of share prices in equity investment decisions (Stanton *et al.*, 2004). Therefore, it is important that the information conveyed to users of accounting narratives reflect financial reality.

Studies in the UK (Bartlett and Chandler, 1997) and in the US (Epstein and Pava, 1993) all show that accounting narratives, especially the chairman's statement or equivalent, are particularly useful and important parts of the annual report. For example, in the UK, Bartlett and Chandler (1997) show that out of 17 sections of the annual report, the chairman's statement is the most thoroughly read by 48% of readership and second in overall importance by private shareholders. Studies of the use of information by investment analysts also show that narrative sections of the annual report are considered important in making investment decisions (Lee and Tweedie, 1981). In an empirical study involving earnings and share price data, Abrahamson and Amir (1996) determine that the president's letter contains useful information about the future of a company. Smith and Taffler (2000) also demonstrate that the content of the chairman's statement is highly predictive of insolvency.

Accounting narratives are relatively new phenomena. In 1973, the American Institute of Certified Public Accountants (AICPA) recommended that financial statements should not be limited solely to quantified information. Amplification, in narrative form, of data included in financial statements may be required. Currently, it is rare to find an annual report which does not contain extensive narratives. These narratives are now encouraged by the regulatory authorities (for example, the management discussion and analysis section is mandatory in the US and the operating and financial review is recommended in the UK). In South Africa the Companies Act of 1973, as amended, requires that a company's financial statements must be accompanied by a narrative report- the director's report- complementing and explaining the main features underlying the results and financial position (Cilliers, Rossouw and Mans, 1995).

Despite their growing importance, comparatively little research has been conducted into accounting narratives in annual reports. Research is particularly timely because of the current discretionary and unaudited nature of accounting narratives. The situation in South Africa is typical of that worldwide. The current local auditing standards does not mandate auditors to report that the accounting narratives contained in the audited financial statements is properly stated. This gives management opportunities to select, discuss and explain corporate financial performance largely untroubled by mandatory constraints. If they wish, management may therefore indulge in impression management by influencing (or attempting to influence) the perceptions of users through accentuation of the positives and downplaying or minimising the negatives. This may, in turn, lead to conflicting messages being given in the narrative statements and in the quantitative financial statements (Smith and Taffler, 1995).

The current paper aims to add to the knowledge of accounting narratives in South Africa, especially their role in impression management. The particular focus of this paper is the chairman's statements from the

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annual reports of 50 JSE listed companies reporting improving performance and 50 JSE listed companies reporting declining performance. These narratives provide a forum to investigate whether companies with improving and declining performance adopt different reporting strategies. A differential pattern of reporting good and bad news may well be contingent upon whether the companies are profitable or unprofitable.

The main purpose of this study is to ascertain whether the amount of news and level of attributions in the chairman's statements of companies with improving and declining performance are significantly different. In particular, we focus on two main issues. First, does the nature and amount of good and bad news reported vary between the two groups of companies? Second, does the attribution pattern (i.e. explanations given by management) for good and bad news varies materially?

This study represents the first research into impression management in accounting narratives in the South African context. Maguire (1997) conducted an event study to investigate the impact on share price of voluntary reporting of financial targets, specifically target rate of return, target dividend payout ratio and target debt-equity ratio. For a sample of JSE listed companies, statistically significant abnormal returns of 2.5% are observed in the event week. Maguire (1997: 33) concludes that the release of voluntary information such as financial targets enables management to signal information pertinent to future company prospects. These results support the general contention that voluntary financial reporting conveys useful information to investors.

South Africa represents a particularly useful context in which to study impression management. There is a long tradition in South Africa of the chairman addressing the shareholders. This statement is voluntary, but conventionally provides an overview of annual corporate performance. In South Africa, unlike the US, litigation by shareholders in a financial reporting context is rare. Consequently, chairmen have more freedom to discuss and debate annual corporate performance in South Africa than in the US. It has been reported that the US legal environment discourages companies from discussing forward-looking information (Weetman and Collins, 1996). It has been reported that US narratives are more constrained through a greater fear of litigation than their counterparts in other countries (Bolger, 1994). Thus, there is arguably more scope in South Africa for impression management.

2. IMPRESSION MANAGEMENT AND BEHAVIOURAL FINANCE THEORIES

The traditional statutory formal communication vehicle between a publicly listed company and its interested constituencies is the corporate annual report.

Corporate annual reports comprise quantitative information, narratives, photographs, tables and graphs. Reports are commonly divided into two sections, with the statutory required financial statements usually assigned either to a rear section, or to a separate volume. The larger up-front section contains mainly voluntary disclosures, the focus of researchers who believe that corporations participate in "consumer engineering" (Lee, 1994) or public relations exercises within this section (Mckinstry, 1996). The glossy overlay of the front half is seen as being capable of overriding the numerical and other statutory messages relegated to the rear of annual reports.

The growth in voluntary disclosures, increasing narrative, and the consignment of statutory financials to the rear (Lee, 1994), provide the means by which management can report corporate achievements, and can facilitate/mould readers' expectations about the reporting corporation. Whether narrative reports provide credible information is a matter of dispute. Increasingly, annual reporting is viewed as an exercise in obfuscation. Sections of the reports are allegedly managed so as to present management in as favourable light as possible, particularly in situations that are identity threatening. For a company with poor or indifferent performance, there is opportunity to create an impression at variance with an overall reading of the report.

As a social concept, impression management is "the conscious or unconscious attempt to control images that are real or imagined in social interactions" (Schlenker, 1980:6). Although impression management is typically discussed as a means of personal influence, in its broader applications, it may occur in any situation where an organisation's representatives act as gatekeepers of information, and in doing so, affect audience's attitudes, opinions and behaviour. Impression management then, provides a rationale for corporate communication, which is controlled and managed, and is influential and persuasive.

Images that have positive expected values are sought, whereas negatively valued images are avoided (Gardner and Martinko, 1988). Different impression management strategies are adopted for different stakeholders (Marcus and Goodman, 1991). Power asymmetries influence how much attention different stakeholders receive (Allen and Caillouet, 1994). They also determine communication strategy: actions made visible by powerful stakeholders will be re-framed by verbal accounts in annual reports; actions made visible by less powerful constituents will be ignored (Neu *et al.*, 1998).

Impression management is said to be "proactive" when it is designed to enhance a corporation's image. The strategic purpose is to build an image of the corporation that ingratiate it with its stakeholders so

as to gain their approval by conveying conformity to the normative rules of their institutional environment (Dowling and Pfeffer, 1975). By self-promotion, acclaiming the corporation's roles, including that of being socially responsible, corporations assert their appreciation for institutional norms and values (Allen and Caillouet, 1994).

Alternatively, impression management is said to be "control-protective" when it is used to protect an established image where that image is threatened as a result of a predicament. The purpose is self-serving. The strategy may be to either admit fault, or deny responsibility by way of excuses, justifications and apologies, disclaimers, self-handicapping, and denouncement. Within narratives, to maintain public image and to protect management from criticism, variations in linguistic construction from good years to bad are found. Language is used to blur distinctions about the causes of poor performance, presenting the company in a positive light (Jameson, 2000). Narratives of good performers are found to be easier to read than those of poor performers (Subramanian *et al.*, 1993; Smith and Taffler, 2000).

Language is used to blur attributions (Thomas, 1997), although others find attributions to be biased (Clarke, 1997). Aerts (1994) refers to such attributions as a "hedonistic bias": a general tendency to attribute anything negative to external, environmental causes, and to attribute favourable outcomes to internal dispositional factors. Additionally, negative performances are explained in technical accounting terms (Aerts, 1994) or in convoluted language (Jones, 1996) while positive performances are explained in strict cause-effect terminology so that management's responsibility for them is clear (Aerts, 1994).

Mirroring narrative research, that into imagery suggests similar patterns. The proposition is that symbols are used to guide interpretation to particular outcomes. Photographs within annual reports do not reflect how people behave, but how one thinks they behave (Anderson and Imperia, 1992). They are used to persuade and distract readers from other information in the report (Simpson, 1999) as well as providing credibility to the report (Graves *et al.*, 1996). Financial graphs are frequently distorted to enhance perceptions of management performance (Mather *et al.*, 1996) so that graphs were more likely to enhance good news, while minimising bad news (Beattie and Jones, 1999).

Research from behavioural finance suggests that investors are not a fixed group, but consist of an ever-changing pool of investors, who as they become older and wiser are replaced by a new cohort of unsophisticated investors ready to be misled emotionally (Huang, 2005). Furthermore, less experienced investors are able to influence market prices (Shleifer, 2000). Finally, even experienced

professional investors are susceptible to systemic biases in their cognitive processing of information resulting in specific presentation formats (Mullainathan and Shleifer, 2005).

Two share price reaction studies (Schrand and Walther, 2000) and Henry, 2006)) and the vast majority of behavioural studies either explicitly or implicitly draw on theories from behavioural finance (that in turn, are based on research in cognitive and social psychology) to explain user susceptibility to impression management.

By providing insights into the underlying reasons for market inefficiency, behavioural finance explains why users might be misled by opportunistic discretionary disclosures. Behavioural finance is based on the premise that under uncertainty individuals do not make decisions based on rationality, but on bounded rationality. This leads to heuristic-driven (rule of thumb) decisions. Additionally, uncertainty leads to individuals taking into account not only the substance, but also the form, of the risky alternatives they face. This means that they consider the framing of choices (the terms in which expected outcomes are expressed), regardless of whether such frames are economically relevant or not. This behaviour under uncertainty results in market inefficiency, where inefficiency is defined as the systemic departure of prices from fundamental values (Shefrin, 2002). Thus, susceptibility to impression management may be a result of either heuristic-driven bias or framing effects.

Under the functional fixation hypothesis, unsophisticated investors are assumed to be incapable of determining the true cash flow implications of accounting data (Hand, 1990). This contrasts with the efficient markets hypothesis where sophisticated investors are believed to be capable of fully interpreting accounting data. Hand extends the functional fixation hypothesis by including both sophisticated and unsophisticated investors. Schrand and Walther (2000) use Head's extended financial fixation hypothesis to explain share price reactions to earnings benchmark comparisons. They show that investor susceptibility to this impression management strategy is due to investors fixating on the information reported to them, due to information processing biases.

Elliot (2006) contends that share price reactions could be due to the perceived content of the information disclosed or may be the result of unintentional cognitive effects. She finds unsophisticated investors to be more easily misled by impression management than professional investors. Due to their cognitive limitations, unsophisticated investors attribute more importance to emphasis/presentation issues than to information contained in earnings numbers.

3. LITERATURE REVIEW

The nature and scope of impression management is well documented in accounting research. The phenomenon is rooted in human psychological and cognitive processes and has been extensively documented in psychology literature. The "Pollyanna effect" is a tendency for people to pay more attention in their thought and speech to positive than to negative aspects in their day-to-day dealings. This was first observed by Boucher and Osgood (1969), and was named after a fictional character in a novel series, involves the tendency to process and recall positive information more easily than negative information. The Pollyanna effect more generally refers to the pervasive human tendency to define the experience of reality as more good than bad. At the extreme, an individual exhibiting the Pollyanna effect may recall only positive information about a past event, for example. While there are individual differences as to what is termed Pollyannism, the generally pervasive tendency associated with the phenomenon has led to a much higher frequency of certain positive words in written language in comparison to that for certain common negative words (Matlin and Gawron, 1979).

Further evidence of the Pollyanna effect, or the use of positive affirmative words is greater than negative words, is offered by Hildebrandt and Snyder (1981). They investigated the accounting narratives of twelve USA companies during the period 1968-77. It was shown that positive words occur significantly more frequently than negative words in the narrative reports regardless of the company's financial position. Hildebrandt and Snyder, (1981) conclude that the hiding of negative information through excessive positive words resulted in a contradiction between the financial figures and narratives provided by management. They also highlight that accounting narratives appear first in the annual report, and are so placed to immediately capture the attention of readers.

Rutherford (2005) examined accounting narratives, as a genre of accounting writing and used word frequencies as the tool of analysis for a sample of UK listed companies. It was reported that word frequencies in the genre are consistent with the Pollyanna effect. The genre employs language biased towards the positive despite authoritative guidance that narratives should be expressed in neutral terms. This study also finds evidence of a greater strength of the Pollyanna effect in poorly performing companies, extending to individual words and classes of words as well as to charged words generally. Rutherford (2005:374) makes a strong case for strict neutrality of genre rules for the construction of accounting narratives. If the generality of departures was towards the positive, sophisticated users would come to expect a degree of positive charging and might "discount" the contents of the narrative accordingly. But unsophisticated users who do not understand the rules

of the genre may interpret the narratives in a naïve manner and may be misled.

Impression management has also been commonly applied in areas such as human behaviour and politics. In theory, company management have incentives to represent their company's performance in the best possible light, which may cause selective financial representation (Revsine, 1991). These incentives include increased remuneration and job security (DeAngelo, 1988). Aerts (2001) points out that these incentives are greatest for listed companies. In practice, impression management is demonstrated across a whole range of accounting issues: the accounting profession (Neu and Wright, 1992); earnings manipulation (Schipper, 1989); graphs (Beattie and Jones, 1997) and photographs (McKinstry, 1996). Impression management of narrative disclosures has the potential to impair the quality of financial reporting and could result in capital misallocations (Merkl-Davies and Brennan, 2007).

Attribution studies in accounting literature seek to determine whether company management systematically attribute favourable news to internal corporate efforts and unfavourable news to external events. Essentially, attribution concerns self-serving human behaviour. It serves the basic psychological human need of presenting oneself in such a way as to gain favourable reactions from others (Turner, 1991). Several US studies investigate and find evidence supportive of attribution theory.

Bettman and Weitz (1983) investigate the president's letter to shareholders in 181 annual reports published between 1972 and 1974. They find that unfavourable outcomes were attributed more to external, unstable and uncontrollable causes than were favourable outcomes. Furthermore, they find that these attributions are most prevalent when companies do worse than expected. Straw, McKechnie and Puffer (1983) investigate the president's letters to shareholders in annual reports for firms with significant earnings increases and firms with significant earnings decreases. They find that the more negative the shareholders' letters, the greater was the attribution to industry and environmental causes and the less was the attribution to company causes.

Salancik and Meindl (1984) analysed the letters to shareholders of a pair of 18 stable and unstable US firms as measured by variation in sales and earnings measures. All management display a strong tendency to credit themselves for positive outcomes and blame negative effects on the environment. Indeed, management are three times more likely to take credit for their firm's good performance than to make any other causal statement. Moreover, they are also three times more likely to blame the environment for setbacks. Clapham and Schwenk (1991) used Salancik and Meindl's methodology to investigate the

president's letters of stable and unstable companies in the US electricity and gas utility sector. Overall, they find that managers in both categories of companies take credit for positive outcomes, but lay blame on the environment for negative outcomes.

Aerts (1994) studied accounting narratives in the annual reports of 50 Belgian companies for the period 1983-1990. It was observed that negative performance is explained by management in technical accounting terms, while positive performance is interpreted in a management initiated cause-effect framework. Rutherford (2005) analysed words used in the accounting narratives of listed UK companies. It was observed that the narratives employ language biased towards the positive. There was greater number of references to profits than to losses, more references to assets than to liabilities, and greater references to positively charged words such as "up" across all companies whose narratives were investigated.

Clatworthy and Jones (2006) investigated the effect of financial performance on the textual characteristics of highly profitable and highly unprofitable listed UK companies. They find differential patterns of reporting in the chairman's statements contingent upon whether the companies are profitable or unprofitable. Compared to profitable companies, unprofitable companies focus less on key financial indicators, use fewer quantitative results, fewer personal references and more passive sentences, and focus more on the future. Overall, their findings are consistent with impression management.

A summary of the prior literature demonstrates that managers use accounting narratives in a self-serving manner, rather than reporting performance objectively. Specifically, management attribute good performance to themselves and bad performance to other factors. However, much of the prior literature is now quite dated. The current study serves to replicate previous overseas findings in the contemporary South African context. There has been an increasing emphasis upon style and presentation in annual reports in recent years. In particular, annual reports are increasingly viewed as public relations documents. In such circumstances, the prevalence of attribution is likely to have increased as managers grasp the opportunity to use accounting narratives to influence users of annual reports.

4. DEVELOPMENT OF HYPOTHESES

Based on the prior literature, we develop two general hypotheses. The first general hypothesis (H1) deals with the overall amount of news presented. The second hypothesis (H2) is concerned with the attribution of the news. These general hypotheses are broken down into three specific hypotheses (labelled H1a- H1c) for H1, and into two specific hypotheses (labelled H2a and H2b) for H2. In the interests of

symmetry and completeness, we have formulated hypotheses for companies with improving performance and for companies with declining performance. However, we would expect the incentives for impression management to be greatest for companies with declining performance.

H1a: There will be no significant differences in the reporting patterns (good news and bad news) of companies which reported improving and declining performance in their chairman's statements

It is important to appreciate that for hypothesis H1a for improving performers, the financial performance data already provide a favourable impression of the company. For companies with improving performance therefore, there would, *prima facie*, seem to be little incentive not to report good news. However, for hypotheses H1a relating to companies with declining performance, there would appear to be more incentive to indulge in impression management, particularly as poor earnings performance may affect managers' tenure (DeAngelo,1988) or compensation (Revsine,1991). In effect, management of companies with declining performance would be expected to attempt to conceal negative outcomes (Sutton and Callaghan,1987) by emphasising the positive aspects of the previous financial year, rather than focussing on the bad news.

H1b: The amount of good news reported in the accounting narratives of companies with improving performance will be equal to the amount of bad news reported in the accounting narratives of companies with declining performance.

H1c: The amount of bad news reported in the accounting narratives of companies with improving performance will be equal to the amount of good news reported in the accounting narratives of companies with declining performance.

For hypotheses H1b and H1c, we would expect the amount of good news in companies with improving performance to be broadly equivalent to the amount of bad news in companies with declining performance. Similarly, we would expect the amount of bad news in companies with improving performance to be broadly equivalent to the amount of good news in companies with declining performance. In other words, the reporting of news should mirror the underlying performance (Abrahamson and Park,1994). Deviations from this pattern would indicate that companies were not reflecting their financial performance in their narrative reporting and were adopting tactics consistent with impression management. That is, companies are attempting to attenuate the negative meaning and accentuate the positive meaning of events (Elsbach and Sutton,1992).

H2: There will be no significant difference in the attribution reporting patterns in the chairman's statement between companies reporting improving performance and companies reporting declining performance.

H2a: Management of companies with improving and declining performance attribute good news equally to internal and external factors.

H2b: Management of companies with improving and declining performance attribute bad news equally to internal and external factors.

Essentially, impression management for hypothesis 2 would involve companies with improving performance attributing good news to managerial effort and bad news to external factors. Companies with declining performance would attribute bad news to the environment, but good news to internal factors.

5. METHODOLOGY

The 100 JSE listed companies in the study were selected in June 2007 from the McGregor's BFANet database. These companies were ranked by percentage change in profit before taxation from their latest published accounts. The top 50 and bottom 50 non-financial JSE listed companies were chosen as dichotomous samples. The sample thus consists of South African companies with strongly improving and strongly declining accounting performance. Henceforth, we term these 'improving performers' and 'declining performers'. The data required from the annual reports and the chairman's statements were downloaded from the websites of the sample companies.

A number of previous studies into the content of accounting narratives use computer-aided analysis packages (Abrahamson and Amir,1996; Balata and Breton,2005). The current study involves a mixture of computer and manual analysis. The computer analysis is used principally to collect the frequency data. However, manual analysis is used for semantic coding and analysis of the data. Manual analysis was dictated by the necessity to identify not only words, but their context and attributions. Although labour intensive, this method resulted in a more sensitive approach. A degree of subjectivity in any analysis of narrative information is inevitable as even computer-based approaches involving systematic counts of keywords require an element of judgment and interpretation.

The coding procedure comprised two stages: the classification of the news (i.e. good, bad or neutral) and attribution analysis (i.e. news attributed internally to management or externally to the environment). The classification of the news involved both coding the number of words in a sentence and also counting keywords. Sentences were considered positive or

negative if they connoted good or bad news for the company, or the environment in which the company operates. In order to be judged as good or bad news, statements needed specific substantiation (for example, by reference to particular aspects of the company's performance).

The following are illustrative examples of sentences coded as good news (G) and bad news (B):

(G) Good news (15 words)

"We are pleased at the performance of the export sector which produced significantly improved profits."

(B) Bad news (25 words)

"The trading environment was adversely influenced by a shift in consumer expenditure towards the Lotto, casino gambling and cell phones which reversed turnover increases in 2006."

The keyword analysis involved coding the number of times the keywords occurred in the chairman's statement using a concordance of positive and negative keywords, which evolved as the coding proceeded. As for the coding of sentences, words were classified as positive or negative according to their connotations for company performance. Further words were added to the list as the analysis progressed. These keywords were recorded and the list used as a basis for analysing subsequent narratives. In order to mitigate problems of subjectivity, the initial coding was checked separately by a second coder (research assistant). Any inconsistencies were resolved by the two coders through discussion.

Importantly, context was considered when determining keywords. For example, "pleased", "improved" and "profits" were counted as individual positive keywords in G above, whereas a positive keyword used in a negative context (such as "increases" in B) was not counted. B contains two words coded as negative, namely "adversely" and "reversed". The word "significantly" in G was not counted as it was deemed a qualifier rather than a keyword itself.

Both the manual approach and computer-based approaches are available to analyse accounting narratives. Ober, Zhao, Davis and Alexander (1999) recommend the manual approach in view of the coding difficulties that arise when using computer software. The manual approach is used in the current research for keyword analysis of accounting narratives. The approach used relies on the classification of the keywords, and the quantitative determination of their importance through counting keywords.

Twenty accounting narratives were test-checked by the research assistant (10 improving performers and 10 declining performers). There was a 90% agreement between the two coders in identifying positive and negative keywords, which compares favourably with

the 80% recommended by Hackston and Milne (1996) and Milne and Adler (1999).

After coding, the sentences were searched for internal and external attributions (i.e. where there was identifiable specific cause for the news). In particular, we distinguished between implicit and explicit attributions (Harvey, Turnquist and Agostinelli, 1988). Explicit attributions were coded where a clear causal link existed between the reported news and any internal or external factors (for example, prompt management action (internal) or recessionary environment (external)).

Explicit attributions were generally identified by the existence of a clear antecedent and consequent outcome. Sentences typically involved linking words such as "because", "as a result of", or "due to". Implicit attributions were coded where an implied link could be established between good or bad news, and internal or external factors. For example, the following statement was coded as an implicit attribution of good news:

"Shareholders should benefit from action undertaken to eliminate unprofitable products, and redeployment of Group resources to reduce costs".

The reports were read by two coders. Importantly, all discrepancies were resolved through mutual discussion.

6. RESULTS

Table 1 shows the basic descriptive financial data relating to the sample. On average, improving performers report large increases in sales, profit before tax, earnings per share and dividends per share. By contrast, declining performers, report large losses in sales, profit before tax, earnings per share and dividends per share. As expected, the differences between the means of improving performers and declining performers are significant at the 1% level in two-tailed t-tests. The two groups therefore, have markedly different financial performance characteristics.

Table 2 presents the descriptive data relating to the accounting narratives contained in the annual reports. All 100 companies' annual reports contain a chairman's statement even though it is not a mandatory requirement. The number of pages devoted to the chairman's statements does not differ significantly between improving and declining performers, being about 3 pages in length, and containing approximately 2 "condensed" pages of text (after deducting pictures, graphs etc.) However, improving performers produce substantially longer annual reports (average 91,4 pages versus 83,3 pages; significant at 10% level). It may well be that

managers of companies reporting improving performance are keen to communicate fully the success of the company, resulting in longer annual reports.

Hypothesis 1 was next tested to ascertain whether the reporting patterns of good and bad news are systematically different between companies with improving and declining performance. The results are shown in Tables 3 and 4. Overall, they are broadly consistent across both types of analysis.

6.1 Hypothesis 1a

The results of Table 3 show that whereas, on average, improving performers devote 436 words to good news, significantly fewer words are devoted to bad news (70 words). Indeed 53,1% of the total words are devoted to good news, but only 8,5% to bad news. On the basis of the amount of good news contained in improving performers' narrative, hypothesis 1a can therefore be rejected. There is a significant difference ($p = 0,001$) in the amount of good and bad news reported by improving performers. This is understandable and logical – one would expect companies with substantial improvements in profitability to spend the majority of the chairman's statement discussing the positive aspects of their performance. However, declining performers, essentially reporters of bad rather than good news for the year (due to substantial falls in profits) devote about the same number of words to both good news (271 words) and bad news (244 words). For declining performers, there is no significant difference between good and bad news. These companies devote about 30% of their narratives to the discussion of good news, but only 27% to bad news. Hypothesis 1a cannot be rejected on the basis of this evidence. There is no significant difference between the amount of good news and bad news reported by companies with declining performance. Even though these companies have experienced substantial downward changes in their profit, they do not focus on that bad news.

We recorded each positive or negative word in the chairman's statement both in total (to give mean keywords) and as a percentage of the words contained in the chairman's statement (to give relative keywords). The results are presented in Table 4. Improving performers' narratives contain 39 positive words on average, but only 6 negative words ($p = 0,001$). In relative terms (i.e. as a percentage of total words), improving performers have 4,8% relative positive words and only 0,7% relative negative words ($p = 0,000$). Therefore, hypothesis 1a can also be rejected on the basis of the average number of keywords in the chairman's statement.

Table 1: Basic descriptive data

| | Improving Performers n = 50 | | Declining Performers n = 50 | |
|-------------------------------|--------------------------------|-------------|--------------------------------|------------|
| | Current Year | Prior Year | Current Year | Prior Year |
| Sales (R million) | 1436,045 ** | 1235,103*** | 567,332 | 524,821 |
| Profit before tax (R million) | 85,347* | - 30,125*** | -18,946 | 20,923 |
| Earnings per share (cents) | 171,3* | - 12,7*** | - 24,8 | 9,7 |
| Dividend per share (cents) | 49,4* | 39,7 | 2,7 | 8,0 |

* ** *** represent significant differences between the means of improving and declining performers at the 1% , 5% and 10% levels respectively in two-tailed t-tests.

Table 2: Accounting narratives in the annual reports of companies reporting improving and declining performance.

| | Improving Performers n = 50 | | Declining Performers n = 50 | |
|-----------------------|--------------------------------|------------------------------|--------------------------------|-----------------|
| | Whole pages | Condensed pages ¹ | Whole pages | Condensed pages |
| Chairman's statement | 3,1 | 2,2 | 2,7 | 1,8 |
| Total pages in report | 91,4*** | n/a | 83,3 | n/a |

*** represents significant differences between means of the improving and declining performers at the 10% level in a two-tailed t-test.

¹. Condensed pages are pages of the chairman's statements that have been counted after removing non-narrative items, such as photographs, charts and diagrams.

Table 3: Good news and bad news in chairman's statements of companies reporting improving and declining performance.

| | Good news | | Bad news | |
|--------------------------|----------------------|----------------------|----------------------|----------------------|
| | Improving performers | Declining performers | Improving performers | Declining performers |
| Mean total words | 436,4* ^{ab} | 271,4 ^c | 70,1* | 244,0 |
| Mean as % of total words | 53,1* ^{ab} | 30,2 ^c | 8,5* | 27,2 |

* represents significant differences between means of improving and declining performers at the 1% level in two-tailed t-tests.

^a represents significant differences between mean good news and mean bad news at the 1% level in two-tailed t-tests for improving performers.

^b represents significant differences between means of improving performers' good news and declining performers' bad news at the 1% level in two-tailed tests.

^c represents significant differences between means of improving performers' bad news and declining performers' good news at the 1% level in two-tailed t-tests.

Despite their poor performance, there are significantly more positive keywords than negative keywords recorded in the chairman's statements of declining performers. There are twice as many mean positive keywords as mean negative keywords – declining performers record 26,7 positive words, but only 14,8 negative words ($p = 0,000$). These results are also supported after controlling for the length of the chairman's statement by using the number of keywords relative to the total number of words in the narrative. In relative terms, there is 3,2% positive words to 1,8% negative words ($p = 0,003$). Therefore, based on keywords, hypothesis 1a can be rejected.

It should be noted that the findings for declining performers' treatment of good news is contingent upon the methodological approach adopted. Using total words (see Table 3), we find no significant difference between the amount of good and bad news. However

for keywords (see Table 4), there are significant differences. This suggests that although declining performers devote broadly equivalent space to discussing good and bad news, they emphasise good news more. There is thus a linguistic bias.

When the reporting patterns of companies with improving and declining performance are compared, Table 3 shows that improving performers report more good news than declining performers. Whereas improving performers report an average of 436 words classified as good news, declining performers report 271 words. In relative terms, improving performers devote 53,1% of their narratives to good news as compared to 30,2% for declining performers. These means are significantly different at the 1% level ($p = 0,000$). Significant differences also exist between improving and declining performers in respect of the average space devoted to discussion of bad news.

Declining performers report significantly more bad news than improving performers, with respective means for the two samples of 244 words versus 70 words ($p = 0,000$). In addition, this is the case for relative bad news (27,2% for declining performers and 8,5% improving performers).

The keyword analysis (Table 4) also confirms this finding. Improving performers' narratives contain an average of 39,1 positive keywords, compared to 26,7 positive keywords for declining performers. Meanwhile, improving performers' narratives contain 6,1 negative keywords and declining performers' contain 14,8 negative keywords. For both positive and negative keywords, the differences between improving and

declining performers are significant ($p = 0,000$ for both). In the case of relative keywords, 4,8% improving performers' narratives are positive keywords versus 3,2% for declining performers. Furthermore, whereas the narratives of improving performers contain 0,7% negative keywords, the narratives of declining performers contain 1,8%. In both cases, these differences are significant at the 1% level ($p = 0,000$). These findings are logical, as companies with improving performance would be expected to report more good news than companies with declining performance and vice versa. Therefore, hypothesis 1a can be rejected.

Table 4: Positive and negative keywords in chairman's statements of companies reporting improving and declining performance.

| | Positive key words | | Negative key words | |
|--------------------------|----------------------|----------------------|----------------------|----------------------|
| | Improving performers | Declining performers | Improving performers | Declining performers |
| Mean key words | 39,1 ^{*ab} | 26,7 ^c | 6,1 [*] | 14,8 |
| Mean as % of total words | 4,8 ^{*ab} | 3,2 ^c | 0,7 [*] | 1,8 |

* represents significant differences between means of improving and declining performers at the 1% level in two-tailed t-tests.

^a represents significant differences between means of positive and negative keyword at the 1% level in two-tailed t-tests for improving and declining performers.

^b represents significant differences between means of improving performers' positive keywords and declining performers' negative keywords at the 1% level in two-tailed tests.

^c represents significant differences between means of improving performers' negative keywords and declining performers' positive keywords at the 1% level in two-tailed t-tests.

6.2 Hypotheses 1b and 1c

Tests on the means for the amount of good news reported by improving performers versus the amount of bad news reported by declining performers reveal striking differences. Whereas improving performers report an average of 436 words of good news, declining performers only report an average of 244 words of bad news. In relative terms, this is 53,1% of the total words by improving performers, compared to 27,2% of total words by declining performers. The means are significantly different at the 1% level indicating a systematic bias in the way that financial performance is reported. In addition, the keyword analysis confirms this pattern. Improving performers report an average of 39,1 positive keywords (4,8% in relative terms), while declining performers reported an average of 14,8 negative keywords (1,8% in relative terms). The difference for absolute number of keywords and relative keywords are also significant at the 1% level. Therefore, there is evidence of asymmetry in the reporting of good and bad news, implying rejection of hypothesis 1b.

Tests of the reporting of bad news by improving performers relative to reporting of good news by declining performers also reveal clear asymmetries. As shown in Table 3, on average, improving performers report 70,1 bad news words, representing 8,5% of their

chairman's statements, whereas declining performers report 271,4 good words, amounting to 30,2% of their chairman's statements. In absolute and relative terms, the differences are significant at the 1% level. The keyword analysis reported in Table 4 reinforces these results as the number of positive keywords reported by declining performers is 4,4 times the number of negative keywords reported by improving performers. Whereas improving performers' narrative include 6,1 negative keywords (0,7% of the chairman's statements), declining performers report 26,7 positive keywords (3,2% of the chairman's statement). In both cases, two-tailed t-tests indicate that these means are significantly different at the 1% level. These results imply rejection of hypothesis 1c.

Overall, as expected, companies with improving performance do report more good than bad news. For companies with declining performance, the situation is more complex. Although they report roughly the same amount of good and bad news, the keyword analysis shows that they focus more on good news. Furthermore, there is a general asymmetry in reporting as improving performers devote more space to good news than declining performers devote to bad news.

In order to test hypothesis 2, we conducted an attribution analysis. As Tables 5 and 6 show, we analyse whether or not the good or bad news is

attributed implicitly or explicitly to either internal factors (such as management decisions), or external factors (such as economic events).

6.3 Hypothesis 2a

Looking first at the good news (Table 5), the credit for good news is taken internally by management. This is true whether one takes an absolute measure (implicit, explicit, or total good news) or a relative measure (average percentage of good news attributed). Moreover, this is true for both groups of companies. For improving performers, implicit attributions are 10 times more likely to be credited to internal rather than external factors (row 1, columns 1 and 2: 148,2 mean words versus 14,7 mean words, $p = 0,000$). For declining performers, the desire to take credit for the little good news is similar: poorly performing management are 8 times more likely to attribute implicitly good news to themselves than to the environment (row 1, columns 4 and 5: 101,3 mean words versus 12,4 mean words, $p = 0,000$).

The pattern for explicit attributions is similar, but less pronounced. Improving performers are 7 times more likely (row 2, columns 1 and 2: 16,3 mean words versus 2,3 mean words, $p = 0,016$), while declining performers are almost twice as likely (row 2, columns 4 and 5: 6,0 versus 2,6 mean words, $p = 0,17$), to credit management rather than the environment explicitly with good news. These patterns are repeated with total mean news attributed (row 3) and the average percentage of good news attributed (row 4). Both results are significant at the 1% level. Therefore, hypothesis 2a is rejected. The attribution of good news is asymmetrical, as management clearly credit themselves rather than the environment with good news: this is the case for both improving and declining performers. However, understandably, managers of companies with improving performance are relatively more likely to take credit themselves.

Table 5: Attribution of good news by companies reporting improving and declining performance.

| | Improving Performers n = 50 | | | Declining Performers n = 50 | | | Total N = 100 | | |
|---|--------------------------------|----------|--------------------|--------------------------------|----------|--------------------|------------------|----------|--------------------|
| | Internal | External | Ratio (Int/Ext) | Internal | External | Ratio (Int/Ext) | Internal | External | Ratio (Int/Ext) |
| Mean good news (implicit) | 148,2* | 14,7 | 10,0 | 101,3* | 12,4 | 8,2 | 249,5* | 27,1 | 9,2 |
| Mean good news (explicit) | 16,3 | 2,3 | 7,1 | 6,0 | 2,6 | 2,3 | 22,3* | 4,9 | 4,6 |
| Total mean good news attributed (implicit and explicit) | 164,5* | 17,0 | 9,7 | 107,3* | 15,0 | 7,2 | 271,8* | 32,0 | 8,5 |
| Average percentage of good news attributed | 54,1* | 5,6 | 9,7 | 35,3* | 4,9 | 7,2 | 89,5* | 10,5 | 8,5 |

* represents significant differences between means of internal and external attributions at the 1% level in two-tailed t-tests.

Table 6: Attribution of bad news by companies reporting improving and declining performance.

| | Improving Performers n = 50 | | | Declining Performers n = 50 | | | Total N = 100 | | |
|--|--------------------------------|----------|--------------------|--------------------------------|----------|--------------------|------------------|----------|--------------------|
| | Internal | External | Ratio (Int/Ext) | Internal | External | Ratio (Int/Ext) | Internal | External | Ratio (Int/Ext) |
| Mean bad news (implicit) | 10,3 | 15,6 | 1,5 | 43,6 | 35,6 | 0,8 | 54,0 | 51,2 | 0,9 |
| Mean bad news (explicit) | 1,3* | 20,7 | 15,9 | 3,2* | 36,7 | 11,5 | 4,5 | 57,4* | |
| Total mean bad news attributed (implicit and explicit) | 11,6* | 36,3 | 3,1 | 46,8 | 72,3 | 1,5 | 58,5 | 108,6** | 1,9 |
| Average percentage of bad news attributed | 6,9* | 21,7 | 3,1 | 28,1 | 43,3 | 1,5 | 34,9 | 65,1* | 1,9 |

*,** represents significant differences between means of internal and external attributions at the 1% and 5% levels respectively in two-tailed t-tests.

6.4 Hypothesis 2b

The findings for explicit attributions for bad news (Table 6) show clear evidence of selective attribution. Improving performers are almost 16 times more likely explicitly to credit external factors rather than internal factors for bad news (row 2, columns 1 and 2: 20,7 words versus 1,3 words on average, $p = 0,001$). In addition, declining performers are 11,5 times more likely to explicitly credit the environment rather than themselves with bad news (row 2, columns 4 and 5: 36,7 mean words versus 3,2 mean words, $p = 0,000$). These patterns are repeated with total mean bad news (row 3) and the average percentage of bad news (row 4). Both results are significant at the 1% level. Despite these differences in explicit attributions of bad news, implicit attribution patterns for bad news are less pronounced. In fact, Table 6 shows that there are no significant results.

Hypothesis 2b can therefore be rejected when the explicit attribution of bad news is considered. Bad news is not attributed equally to internal and external causes. Companies explicitly blame the environment rather than themselves for bad news, and this applies to both improving and declining performers. However, for implicit attributions, we can make no inferences about impression management.

In conclusion, we can summarise the results from Tables 3-6 as follows. Tables 3 and 4 imply impression management by declining performers, but not necessarily by improving performers. However, the attribution data in Tables 5 and 6 are indicative of impression management by both groups.

7. DISCUSSION

The findings from this research support the idea that accounting narratives represent one method of impression management available to company management. Therefore, this research adds to the growing body of evidence which suggests that impression management occurs across a whole range of accounting research issues. This is not surprising given that managers have incentives to represent their companies' performance in a favourable light. In this regard, impression management by the managers of companies is consistent with the psychology literature, which demonstrates that individuals respond to societal pressures to portray themselves in the best possible light.

Impression management in accounting narratives is demonstrated in two principal ways. First, improving performers present more good news than bad news, in terms of both overall words and keywords. This is understandable and in line with the underlying corporate performance. Declining performers do not dwell on their bad news. The keyword analysis suggests that they focus more on the good news.

Prima facie, for declining performers there is a mismatch between the accounting narratives and the financial statements as these companies do not address the issue of their poor financial performance head on. In fact, in terms of keywords, they accentuate the positive rather than the negative. Second, firms attribute the causation of the news in a way that reflects well upon themselves. In general, irrespective of corporate performance, companies attribute good news to themselves, rather than to the environment. Furthermore, there is a general, although non-universal tendency for companies to attribute bad news to the external environment rather than to themselves. News is thus attributed in a self-serving manner.

Overall, these results indicate that management seek to attribute good news to themselves and bad news to the environment. The principal management reporting strategy appears to seek ways to avoid specific blame for bad news. Whether or not this strategy is conscious or unconscious is hard to judge. The two competing motivations are difficult to disentangle for several reasons. Corporate success may, in reality, be caused by management and failures by the external environment. In this case, the management attributions are true: managers are themselves responsible for corporate success, but the environment is responsible for corporate failure.

However, managerial attributions may be delusive (either wholly or partially) and not accurately reflect the real world. The reasons for managers' attributions may be twofold. First, they may really believe that they are the agents of success, whereas external factors are responsible for failure. In this case, their decisions are worrying because they may not adopt rational management strategies. As Kunda (1990) points out, cognitive processes may well contribute to these beliefs. Second, managers may correctly understand their financial performance, but seek to manage the presentation of the news through impression management. This is a perfectly rational coping mechanism. Managers are adopting an impression management strategy whereby they are self-interestedly attempting to influence the perceptions of users. This seems the most likely explanation given that the patterns of attributions vary between implicit and explicit attributions.

Fiol's (1995) study of the asymmetry of internal and external corporate communication also points to the importance of impression management. The most likely explanation of the strength of the external bad news attribution appears to be a deliberate attempt by management to manage the presentation of the accounting narratives. However, given the existence of alternative possible explanations, it would be useful to conduct research into these, possibly through a perceptions-based study.

The role of the auditor's review of the chairman's statement is worthy of comment. None of the auditors' reports mentioned any inconsistencies between the companies' financial statements and the accounting narratives. This is understandable, for the current state of financial reporting auditors do not formally audit but instead review the chairman's statement to ascertain consistency with financial statements. Companies have been encouraged to give a more comprehensive overview of their annual performance by providing written narratives. However, the value of this fuller provision is undermined if there is a mismatch between the qualitative and quantitative presentation. The expanded role of the auditor in reviewing accounting narratives is an issue worthy of further research.

8. CONCLUSION

This paper investigates the chairman's statements in the annual reports of 50 top and 50 bottom JSE listed companies as measured by percentage change in profit before taxation. Systematic patterns are found in reporting good and bad news. These patterns are evident irrespective of company performance. Companies with improving performance concentrate on good news rather than bad news. However, declining performers do not discuss and analyse the nature of, and reasons for, their poor performance. At best, they discuss both good and bad news equally; at worst they focus on good news. This bias is also reinforced by the asymmetry in the reporting of good and bad news. Improving performers report significantly more good news than declining performers report bad news.

Our results are broadly consistent with attribution theory. Managers of companies with improving and declining performance prefer to blame the environment for bad news, but take the credit themselves for good news. Management therefore uses the chairman's statement to place a positive emphasis on financial performance and attempts to deflect attention away from their responsibility for poor financial results. This trend is disturbing because annual reports are increasingly becoming public relations documents and this provides management with greater opportunity to use accounting narratives to influence users of annual reports. These results are consistent with previous impression management research. The results of this investigation support the "Pollyanna effect" observed by psychologists. The Pollyanna effect can be interpreted as a form of impression management by which individuals (such as company managers) control the impression others form of them by using language biased towards the positive.

The results of this research have important implications for the accounting profession and also the investment community. The chairman's statement occupies a prime location in the annual report, and is regarded as important by private investors and

sophisticated users as it provides information beyond that required for statutory financial reporting. Currently, this accounting narrative is not formally audited. Instead, it is reviewed by auditors to ensure consistency with the financial results. For declining performers, these narratives downplay the bad news. This may prejudice the provision of a balanced, true and fair view of the company's financial performance. Our results provide support for the debate relating to the standardisation of the accounting narratives in the annual report and the possible audit of these sections, although audits have proved lately not to be a sufficient obstacle to manipulation. Mandating companies to report certain performance issues and providing certain figures could benefit investors and will help to avoid the current situation where companies appear to report what best suits them in their accounting narratives.

When interpreting these results, it is important to consider the following two caveats. First, the sample was deliberately constructed so as to draw upon companies whose accounting performance has changed markedly. This sample has clearly demonstrated the existence of differential attributions. Intuitively, there seems to be no reason why these results should not be generalised to all companies nor why these findings should be unique to South African companies. However, this may not necessarily be the case. Therefore, further research will be necessary to test this.

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