Clarity and Conciseness of Financial Narrative Disclosures:
Does the Practice Statement Matter?

Authors

Ekaete Efretuei

Liverpool Business School, Liverpool John Moores University, Liverpool, UK,

Kemi Yekini

Aston Business School, Aston University, Birmingham, UK

To evaluate the necessity for regulatory actions outlined in the IFRS practice statement exposure draft on the revised management commentary, ED 2021/6 (IFRS Foundation, 2021).

The extent to which regulation influences changes in narrative complexity and the need for such regulatory interventions has not been thoroughly examined (de George et al., 2016; Lang & Stice-Lawrence, 2015)

The exposure draft Question 11a poses the following question:

'Chapter 13 proposes to require information in management commentary to be complete, balanced, and accurate and discusses other **attributes that can make that information more useful**. ... Do you agree with these proposals? Why or why not? If not, what do you suggest instead and why?' (ED 2021/6)

Management commentary represents the narrative components of an annual report and is defined broadly by the exposure draft [section IN3] as a '... report that complements an entity's financial statements'.

The Study......

Addresses question 11a, raised in the IFRS practice statement exposure draft on the revised management commentary [ED 2021/6], by investigating the association between IFRS adoption and the clarity and conciseness of financial narrative disclosures.

The IASB, in its 'Disclosure Initiative' discussion paper, recognized the need for a standard on disclosure complexity due to the use of unclear descriptions or technical jargon in financial disclosures (IASB, 2017).

This led to the publication of the IFRS Foundation document in October 2017, titled *'Better Communication in Financial Reporting— Making Disclosures More Meaningful'*, aiming to enhance companies' communication effectiveness, the IASB did not further develop the principles at that time

The latest follow-up aligned with the disclosure attributes is question 11a of ED 2021/6, which this paper addresses

The ED 2021/6 outlines key disclosure attributes, with Clarity and Conciseness essential for enhancing **understandability** and fulfilling management commentary's purpose. ***Information is more useful when it is clear and concise (par 13.2)***

ED 2021/6 paragraph 13.14 defines 'Clarity and Conciseness' as:
"*For management commentary to be clear, it needs to use plain language and avoid jargon and unnecessary technical terminology*".

Paragraph 13.17c notes "For management commentary to be concise "*use simple, clear language and short, clearly structured sentences and paragraphs.*"

Studies show these attributes significantly impact investor and creditor decision-making (e.g., Bai et al., 2019; Chen et al., 2024; Lawrence, 2013).

The study examines how IFRS adoption impacts disclosure complexity, particularly in report length and word intricacy.

The IFRS introduction/revisions to various standards (IFRS 9; 13; 15; 16) over the years has increasingly enhanced complexity. Users are becoming more reliant on qualitative disclosures (*management commentary is going to become more important in assisting statement users - sustainability, intangibles, R&D disclosures*)

We argue that IFRS-aligned disclosures may show increased vocabulary complexity, thus suggesting less clarity and conciseness and therefore a shift away from "Clarity and Conciseness" (IFRS Practice Statement ED 2021/6)

The evidence on whether regulation affects the complexity of narratives or whether regulatory action is needed is limited (de George et al., 2016; Lang & Stice-Lawrence, 2015; IFRS Foundation, 2021).

We investigate whether observed changes in narrative complexity, as recorded in the wider literature, would require further regulatory actions on narratives as outlined in the IFRS management commentary exposure draft.

Our study differs from existing studies on IFRS and complexity/readability measures.

While others are on disclosure quality/quantity effect of IFRS (Garefalakis et al., 2013; Stent et al.,2013)

And some studies focus on complexity and its association with other accounting variables.

We provide evidence of the IFRS effect on firm's disclosure clarity and conciseness.

ED 2021/6 page 15, question 11, "Is Clarity and Conciseness of disclosures important"?

Why should this bother the regulators?

If regulation (IFRS) disclosures are associated with decreased clarity and conciseness, YES!

Two key theoretical viewpoints drive textual analysis literature – Management obfuscation and the information hypothesis:

If obfuscation, IFRS should enhance the quality of narrative disclosures;

However, if information perspective, then IFRS reports will become lengthier and may contain more complex narratives.

Hypothesis - Regulation and Understandability

We hypothesise as follows:

Hypothesis 1 (H1): Narrative disclosures associated with IFRS increase the level of complex narratives, which decreases the clarity and conciseness of financial disclosures.

Informed by A Conceptualised Research Question: Does Regulation Exacerbates Disclosure Understandability?

- **IFRS Adoption Expectations**: Likely to result in longer, more complex disclosures, reducing clarity and conciseness.

- **IFRS Management Commentary Goal**: Emphasizes clarity and conciseness as key disclosure attributes.

- **Clarity and Concise Measures**:
  - **Single-Dimensional Measure** (e.g., fog index with length and complex words): Primarily indicates **obfuscation**.
  - **Multi-Dimensional Measure**: Targets **informational aspects**, capturing business and disclosure-specific complexities.

- **Hypothesis Arguments**: IFRS-induced disclosure complexity may obscure information or provide depth, thus decreasing clarity and conciseness.

Empirical model: FE model with robust standard errors

$$Complexity_{it} = Intercept + \beta_2 year\_ifrs_{it} + \beta_2 firm\_size_{it} + \beta_2 firm\_age_{it} + \beta_2 earn\_vol_{it} + \beta_2 price\_vol_{it} + \beta_2 bus\_comp_{it} + \beta_2 geo\_comp_{it} + \beta_2 earns_{it} + \beta_2 US\_Listing_{it} + \varepsilon_{it} \qquad (1)$$

- Where Complexity is the dependent variable (length, word complexity measures or fog readability score of firm i at time t),
- Where year_ifrs is estimated using a fixed shift approach – 'variable indicating whether an issuer is using IFRS (IFRS = 1) or domestic GAAP (IFRS = 0) (Moscariello et al., 2014; Almaharmeh and Masa'deh, 2018)
- Regression model incorporates standard controls and firm fixed effects (Doukakis, 2014; Lang & Stice-Lawrence, 2015).

Data Collection: We downloaded annual reports for companies listed in the 2012 FTSE ALL SHARE index from their respective company websites

File Conversion: The annual reports are presented in PDF format. Use the 'pdftotext' program to extract text from pdf for analysis

Text Parsing/Preprocessing: A Perl code is used to parse the text files, removing text encodings and full stops between two numbers; other non-text elements.

Readability/Complexity Analysis: The cleaned text files are inputted into the Lingua EN Fathom Perl readability module. They are coded to capture complexity words.
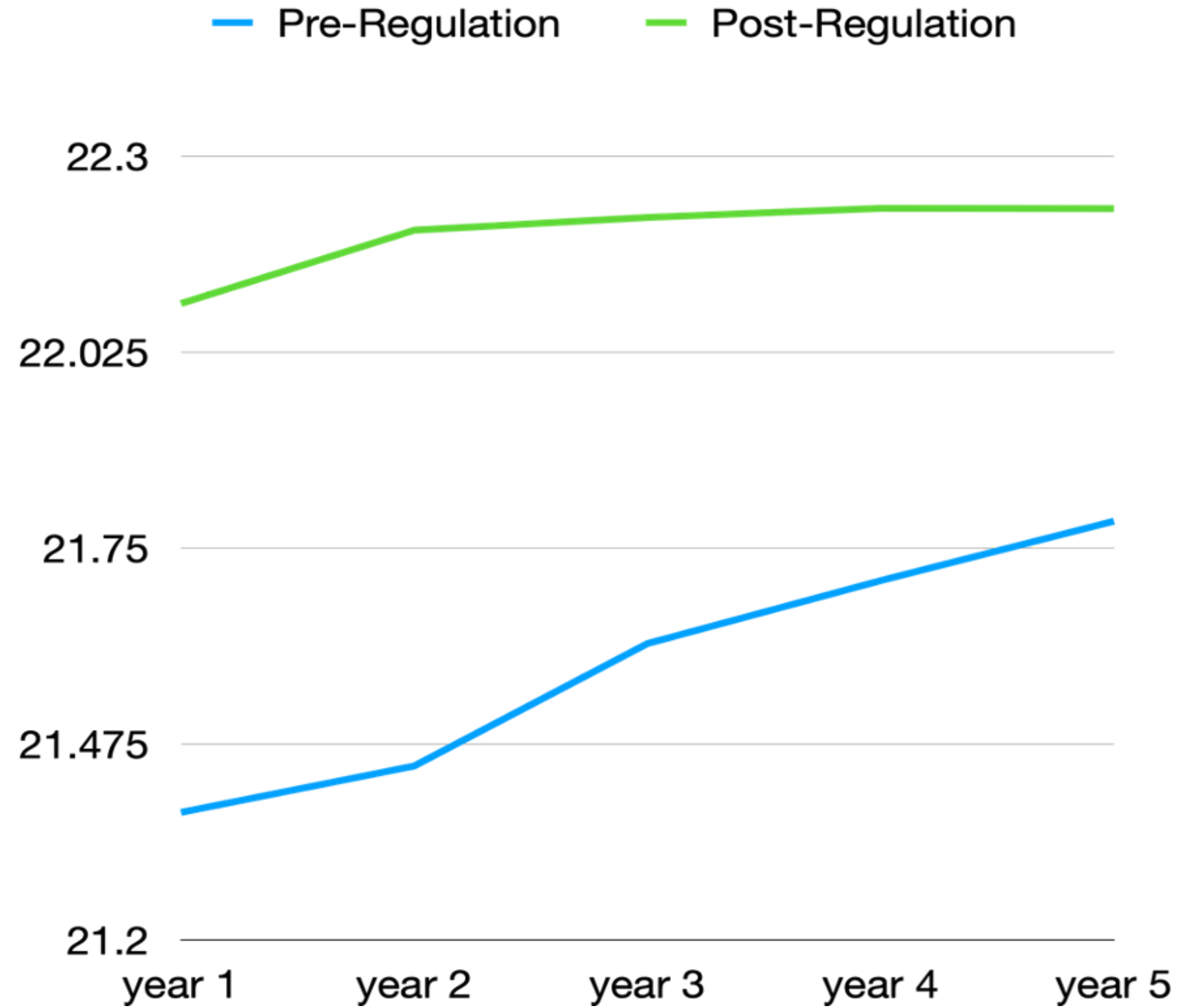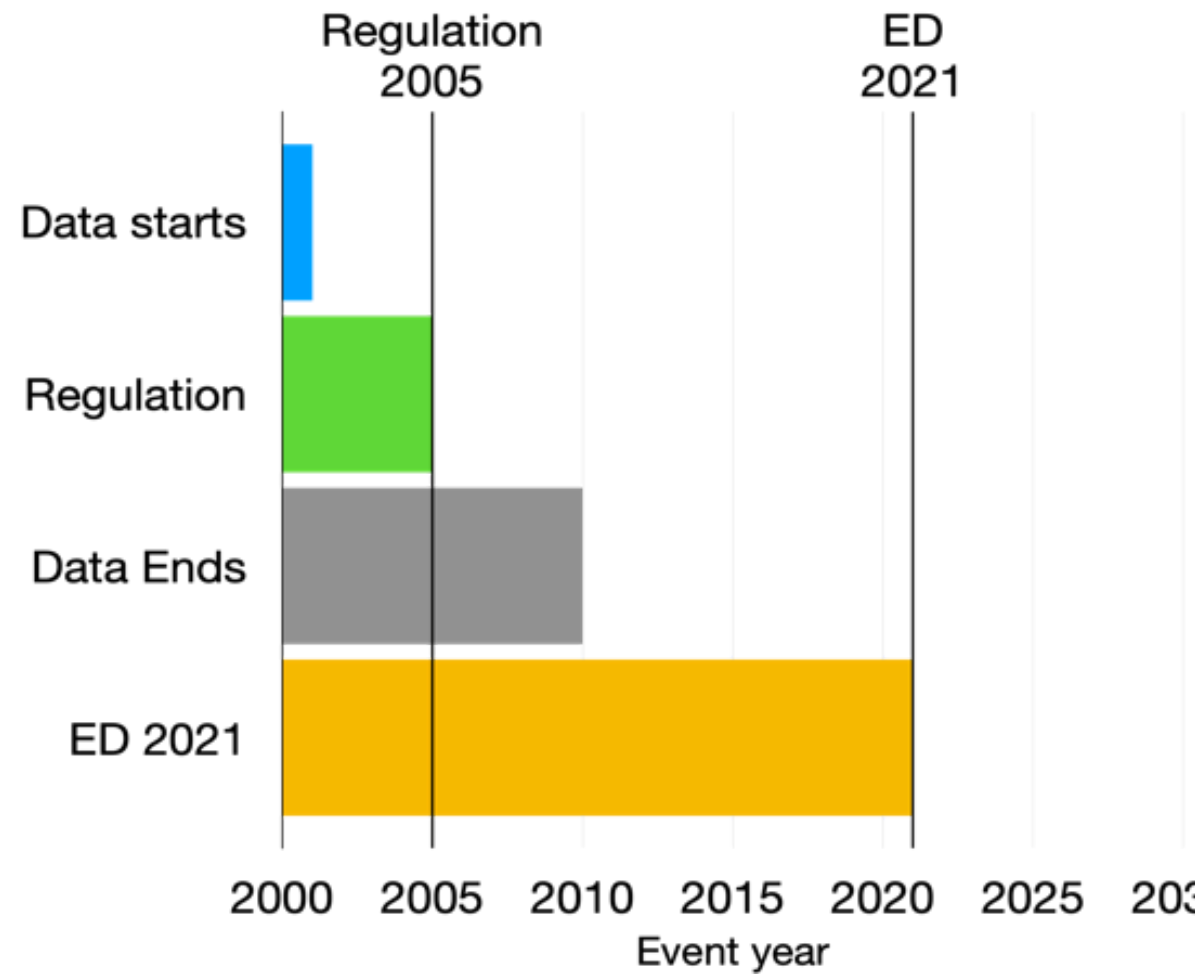
Data Sample: FTSE AllShare Index
Data Screening: Pre IFRS (2000-2004);
Post IFRS (2006-2010);
Final Sample: 2,127 fiirm years

IFRS Clarity and Concise Definitions (ED 2021/6) mapped with Complexity Variables

We use two clarity measures.
Word complexity: labelled as complex_words

Keyword complexity: labelled as complexity_words

Theoretical Perspectives

|	Complexity of Narrative Language	Scope and Range of Narrative Content
	Clarity	**Conciseness**
	Complex Words – *words with three or more syllables* (par. 13.14 Plain Language)	Length – *Natural log of number of words* (par 13.17a - avoid generic information) (par 13.17b - avoid duplication of information)
	Complexity Words – *Words in Loughran & McDonald (2023) Word list* (par. 13.14 Avoid jargon) (par. 13.14 Avoid unnecessary technical Language)	Fog Index – *average word per sentence + complex words* (par 13.17c - use simple, clear language and short, clearly structured sentences and paragraphs)

Information
Complex words (L&M, 2014)
Length - increased disclosure

Obfuscation
Complexity_words (L&M, 2023)
Fog Index - Lang&Stice(2015)

Appendix 3: Loughran and McDonald (2023) Complexity word list

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ACCRUES AFFILIATES BANKRUPTCIES CARRYBACK CARRYFORWARD
CARRYFORWARDS COLLATERAL COLLATERIZATION COMPLEX
CONVERTIBLE COUNTERPARTIES COUNTERPARTY COVENANT
COVENANTS DERIVATIVE DERIVATIVES ENTITIES FLOATING GLOBAL
HEDGED HEDGES INFRINGEMENT INTANGIBLES INTERNATIONAL
LAWSUIT LAWSUITS LEASEHOLD LEASES LESSORS LICENSING
LITIGATION MERGERS MERGING OUTSOURCE PARTNERING
RECLASSIFIED REPATRIATE REPATRIATED REPATRIATION
RESTRUCTURE RESTRUCTURED RESTRUCTURING REVALUATION
REVOCATION SECURITIZATIONS SECURITIZED SEGMENTS SOVEREIGN
SUBLEASES SUBSIDY SWAPS VENTURES WORLDWIDE
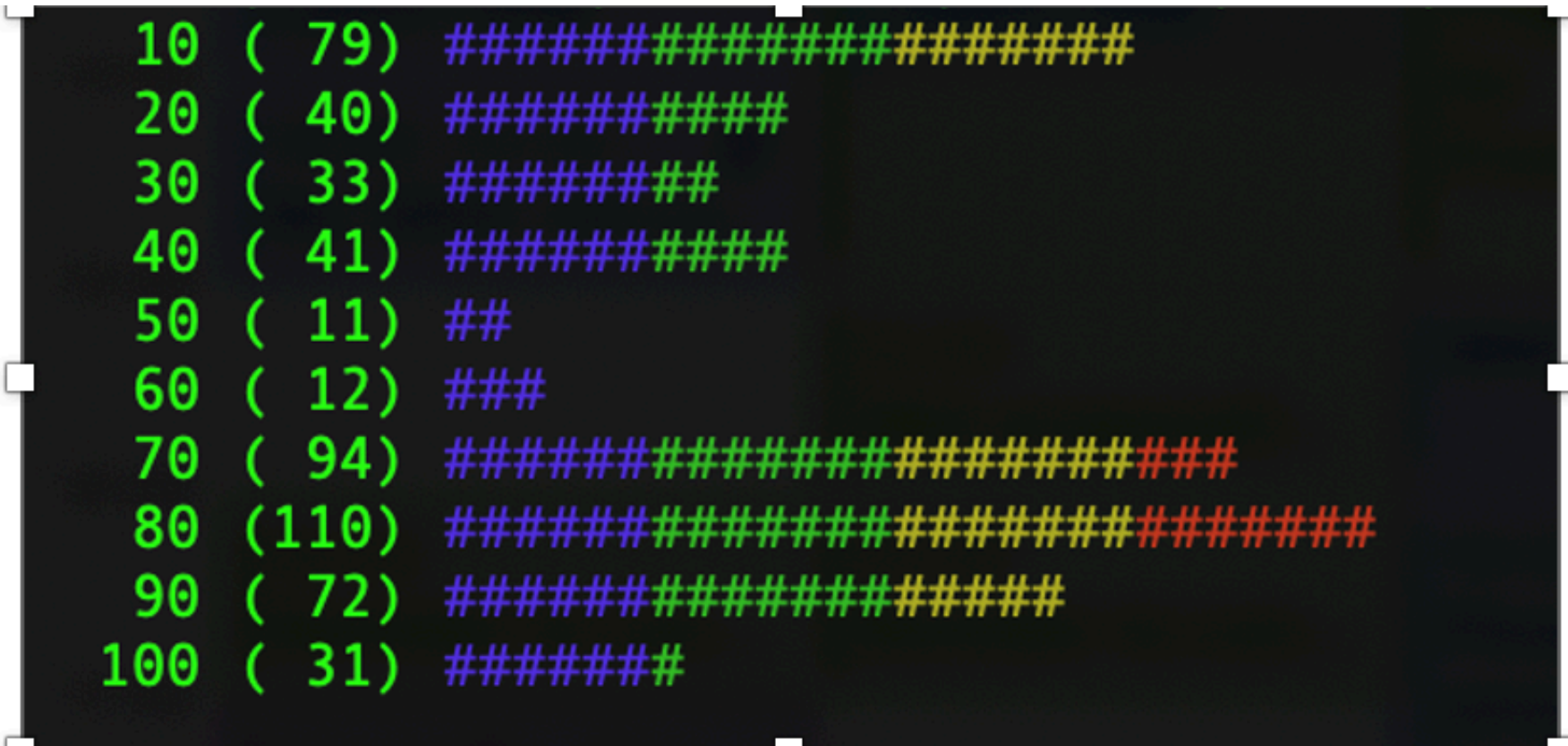
Graph Illustrating obfuscating complex words occurring in BAT 2004/2006 reports
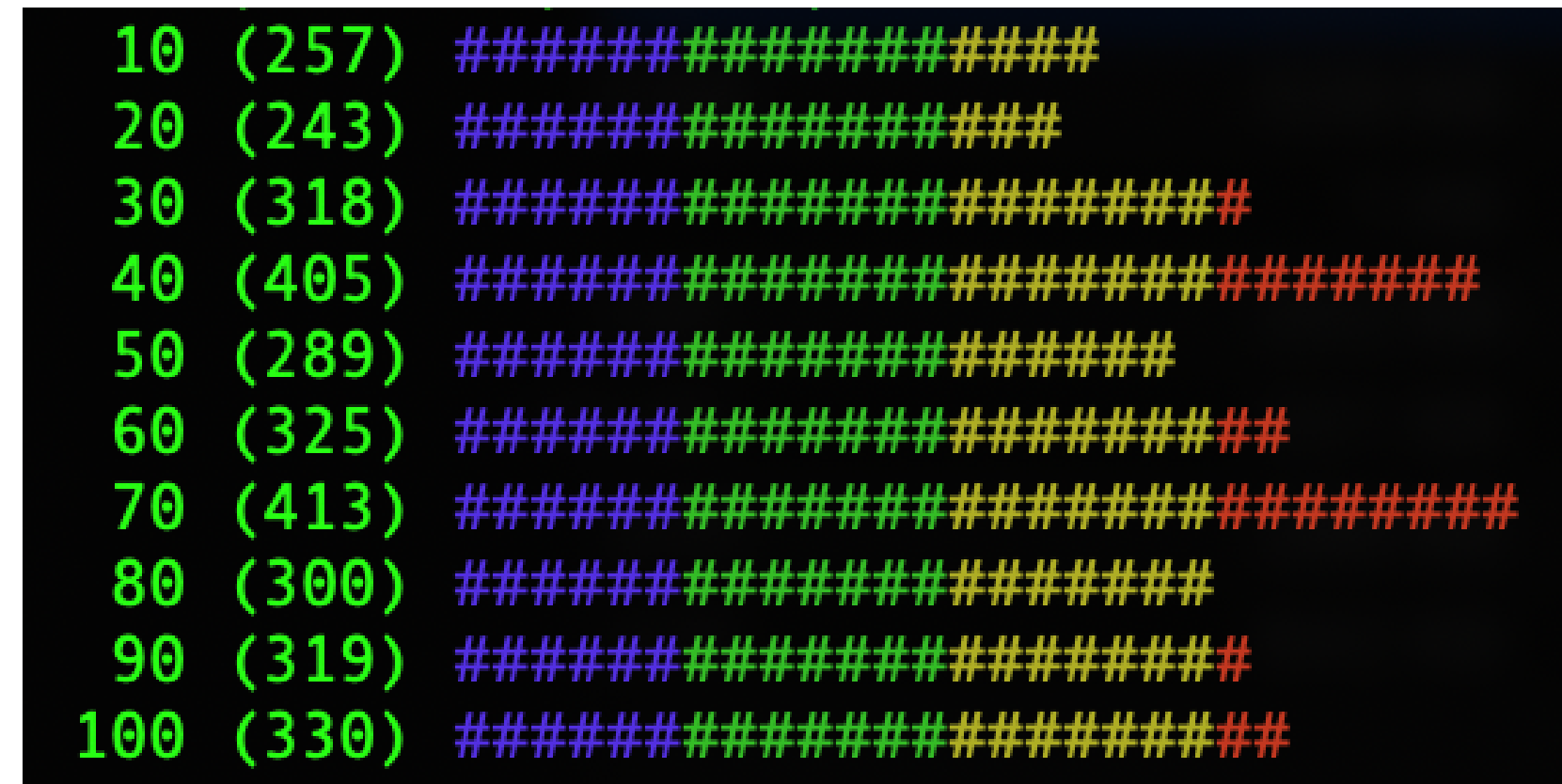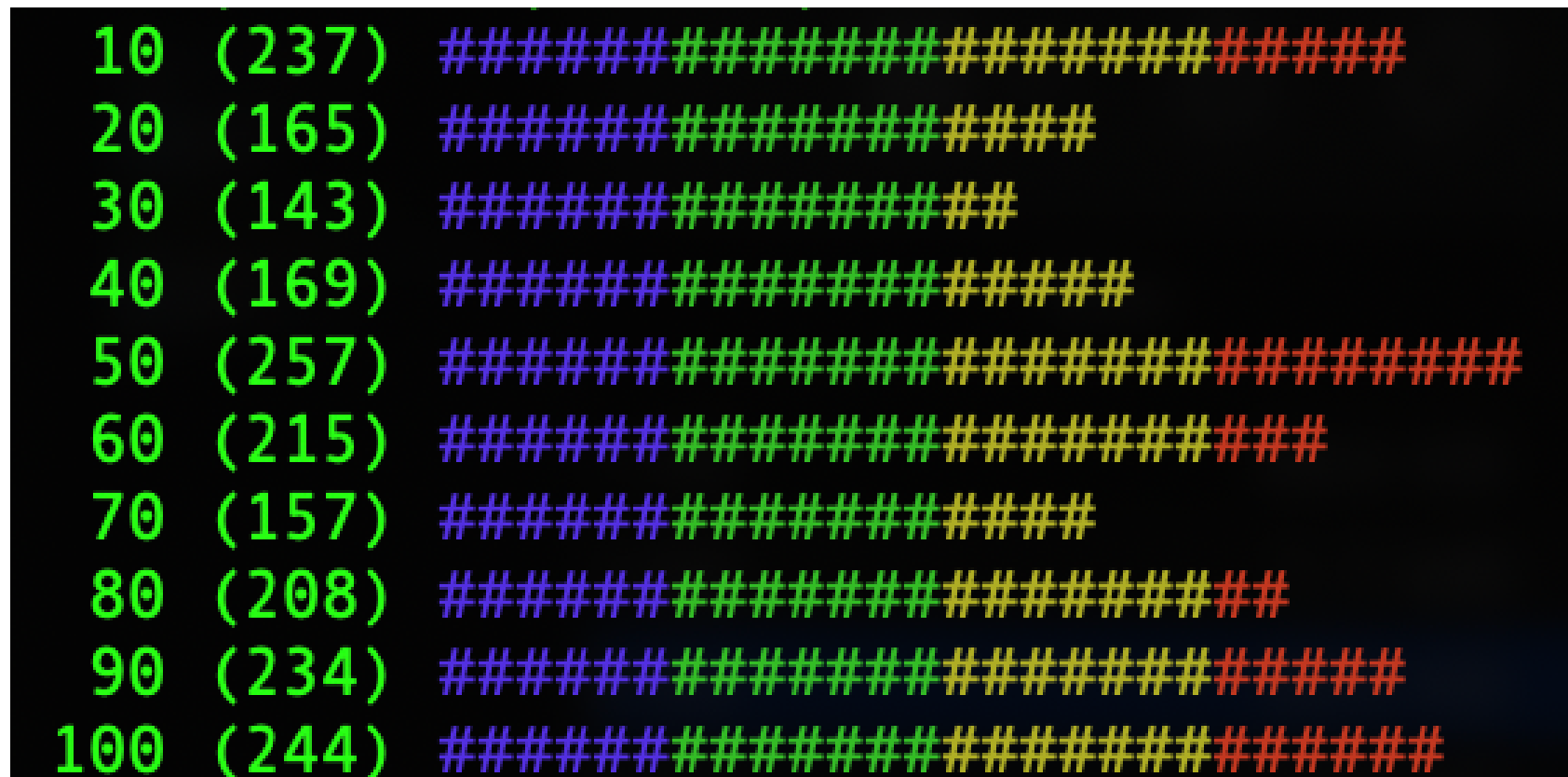
Graph Illustrating informative complex words occurring in BAT 2004/2006 reports

Results

Appendix 2: Variable definitions

Variable	Full Name	Definitions
length	Length	Log of the number of words in the annual report [(word_complexity + wordpersence)*0.4]. "The interpretation of the fog index is score ≥ 18 =
fog	Fog	unreadable text, 14 -18 = difficult text, 12 – 14 = ideal, 10 -12 = acceptable, and 8 – 10 = childish text" (Li, 2008).
%_ComplexWords	Complex words	[(Number of complex words in the annual report/total number of words in the same report)*100]. Complex words are words with three or more syllables.
%_ComplexityWords	Complexity words	The count of words listed in appendix 3 that were retained based on the model selection process off Loughran & McDonald (2023), divided by the total number of words appearing in the Form report x100.
firm_size	Firm size	The natural logarithm of a firm's total assets
firm_age	Firm age	(date of 02/07/relevant year-end) less date of incorporation).
earn_vol	Earnings volatility	The standard deviation of the annual earnings (operating earnings after depreciation) of the five years before the analysis.
price_vol	Price volatility	A stock's average annual price increases or decreases from the mean price for each year. For example, a stock price volatility of 20% indicates that the stock's annual high and low price has shown a historical variation of +20% to -20% from its annual average price.
bus_comp	Business complexity	Natural logarithm of the number of business segments.
geo_comp	Geographical complexity	The natural logarithm of the number of geographical segments.
earns	Earnings	The operating income after depreciation scaled by total assets of the firm scale the firm.
year_ifrs	IFRS adoption	Equal to one for an IFRS adoption year and zero otherwise.
US_listing	US listing	Variable equals one if the firm is listed in a United States security market and zero otherwise.
time1	Time 1	the variable increases with the year, with an additional value of 1 for each year.
time2	Time 2	It takes the value of zero for pre-IFRS adoption years with an additional value of 1 for every post-IFRS adoption year.
Industry	Industry	Industry Classification Benchmark

Table 4: Descriptive statistics

Panel A: Full Sample

Variable	mean	std. dev	p25	p50	p75	N
number of words	35906	23928	20277	30645	43704	3659
fog index	22.009	1.350	21.305	22.076	22.844	3659
%_ComplexWords	26.763	1.373	25.921	26.798	27.602	3659
%_ComplexityWords	0.400	0.192	0.265	0.385	0.509	3522
firm size (total assets)	6.653	1.941	5.345	6.342	7.617	3571
earnings (£/year)	0.076	0.119	0.023	0.069	0.123	3569
price volatility	28.866	10.357	21.521	27.147	34.117	3026

Panel B: year_ifrs = 0

Variable	mean	std.dev	p25	p50	p75	N
number of words	24152	15509	15896	20390	26624	1389
fog index	21.689	1.480	20.908	21.755	22.633	1389
%_ComplexWords	26.407	1.386	25.587	26.457	27.278	1389
%_ComplexityWords	0.358	0.212	0.217	0.325	0.457	1323
firm size (total assets)	6.419	1.989	5.019	6.112	7.428	1343
earnings (£/year)	0.065	0.113	0.019	0.061	0.113	1341
price volatility	28.252	11.276	20.489	25.645	32.726	1171

Panel C: year_ifrs = 1

Variable	mean	std.dev	p25	p50	p75	N
number of words	43098	25289	28271	38047	50118	2270
fog index	22.205	1.224	21.528	22.231	22.939	2270
%_ComplexWords	26.980	1.320	26.170	27.010	27.768	2270
%_ComplexityWords	0.427	0.173	0.306	0.419	0.5333	2199
firm size (total assets)	6.794	1.898	5.509	6.450	7.737	2228
earnings (£/year)	0.083	0.123	0.027	0.073	0.127	2228
price volatility	29.253	9.716	22.294	27.863	34.887	1855

Results

Table 6: Narrative complexity and mandatory IFRS – Hypothesis test

	length	%_ComplexWords	fog	%_ComplexityWords
	(1)	(2)	(3)	(4)
year_ifrs	**0.232***	**0.512***	**0.203***	**0.106***
	(7.61)	**(5.85)**	**(2.75)**	**(14.71)**
firm_size	0.0494*	0.0740	-0.0259	0.0325*
	(2.57)	(1.48)	(-0.60)	(3.15)
firm_age	0.0732***	0.00854	0.0652**	-0.00757***
	(12.77)	(0.82)	(4.27)	(-6.12)
earn_vol	-0.00000660	0.0000637	-0.0000859	-0.00000752
	(-0.39)	(1.38)	(-1.49)	(-0.82)
price_vol	0.00204	-0.00571	0.00582	0.000716
	(1.48)	(-0.74)	(1.09)	(1.56)
bus_comp	0.0440	-0.00659	-0.0297	0.0132
	(1.79)	(-0.08)	(-0.45)	(1.29)
geo_comp	0.0449*	0.0386	-0.0250	0.0293
	(2.34)	(0.33)	(-0.31)	(1.93)
earns	0.00807	-0.631*	-0.370	-0.116
	(0.10)	(-3.04)	(-0.98)	(-1.87)
US_Listing	0.144	0.360	0.433*	-0.0338
	(1.62)	(1.52)	(3.02)	(-1.02)
_cons	7.175***	25.66***	19.60***	0.355**
	(53.13)	(54.19)	(51.29)	(4.70)
N	2127	2127	2127	2059
adj. R-sq	0.693	0.114	0.087	0.229

- Alternative Specifications of Regression model –

  Robustness Tests:
  - Regression model with alternative time effects
  - Regression model with industry interaction effects
  - Regression model with lagged dependent variables
  - Alternative specification to fixed approach – interactive approach
  - Alternative sampling using a matched sample analysis

- **The study finds......**

  ○ **Increased Textual Disclosure:** Higher word count in reports post-IFRS.

  ○ **Higher Word Complexity:** Reports contain more complex words.

  ○ **Decrease in Clarity and Conciseness:** Rising fog index, length and complexity indicates a decrease in clarity and conciseness over time.

- **The study's findings responds to question 11a of ED 2021/6 by demonstrating that the findings agree with the ED proposal to 'require information in management commentary to be complete, balanced and accurate' in line with the attributes of clarity and conciseness detailed in chapter 13.**

- **Recommendations**

  - Addressing 'Understandability': Emphasize clear guidance on narrative complexity in IFRS disclosures.

  - Focus for IFRS Regulators: Consider potential revisions to enhance disclosure clarity and investor usability.

- **Contributions to Knowledge**

  ○ We differ from others by applying two measures of word complexity: complex words component of the fog index and complexity words to capture the exposure draft definition of clear and concise.

  ○ This allows the study to directly contribute to question 11a of ED 2021/6 and thus provide unique insights for standard-setters and practitioners on critical areas to enhance disclosure quality in financial reporting through its focus on complexity at the word level.

In September 2024, the staff paper for the IASB project update meeting noted the following:

The IASB has decided to finalise the project by making targeted refinements to the proposals in the Exposure Draft Management Commentary, published in May 2021

 - the clarity & concise requirements of the Exposure Draft are supported by this study's academic evidence while also providing evaluation tools.

- there is currently no academic evidence on this - this paper provides this for the revised statement about to be issued in the first half of 2025.

Expand All +

FOR THE BASIS FOR CONCLUSIONS, SEE PART C OF THIS EDITION

BASIS FOR CONCLUSIONS

[Draft] IFRS Practice Statement 1 *Management Commentary*

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*  Other International Brands While our in
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Thank you!