CHAPTER 1
INTRODUCTION

1. UNDERSTANDING READABILITY

1.1 EVOLUTION OF READABILITY

In 1998, 46 percent of all accidental deaths of infant and children aged 1 to 14 were caused by traffic accidents (National Center for Health Statistics, 2000). A study (Johnston et al. 1994) demonstrated that the only strongest risk factor for damage in a traffic accident is the inappropriate use of child-safety seats. Another research study (Kahane 1986) discussed that, when properly used, child safety seats lessen the hazard of fatal injury & hospitalization by 71% & 67% respectively. To be effective, however, the seats must be installed correctly.

Public-health experts Dr. Mark Wegner and Deborah Girasek (2003) supposed that poor understanding of the installation instructions may put in to this problem. They give the impression of being into the readability of the directives and published their results in the medical journal Pediatrics. The story was covered widely in the media.

If the National Adult Literacy Study is referred (National Center for Educational Statistics, 1993), which says that, the average adult reads at the 7th grade level. They also mentioned specialists in health literacy who suggested that public disclosure document be written at the fifth or sixth-grade reading level.

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Doak et al., 1996\textsuperscript{6} found that the average reading grade of the 107 instructions observed was the 10th grade, too complicated for 80 percent adult readers. When passages go beyond the reading skill of readers, they habitually discontinue reading. The authors did not attend to the design, comprehensiveness, or the organization of the instructions. The study did not declare that the instructions were poorly written. If checked by the SMOG readability formula, they found the commands were written at the wrong grade level. Many other researchers, through much research studies, have brought together golden rules of writing the documents. These rules are not considering of medium:

• Use small, easy, familiar words
• Avoid terminology.
• Use culture-and-gender-neutral language.
• Use exact grammar, punctuation, and spelling.
• Use simple sentences, active voice, and present tense.
• Begin instructions in the essential mode by starting sentences with an action verb.
• Use simple graphic elements such as bulleted lists and numbered steps to make information visually accessible.

It has been seen that technical publications do not track these guidelines and are read only by a small fraction of the likely readership. One explanation may be given that the writers are not aware with the conditions and research of these rules. (DuBay, 2004)\textsuperscript{7}

\textbf{1.2 READABILITY DEFINED}

Readability is what that explains some texts are easier to read than others. It is often puzzled with legibility, which concerns style and layout. Readability talks about the ease with which a text can be read. Numerous mathematical formulas have been developed to support writers in computing the readability of their script. Most authors in their formulas (indexes) include sentence length and a few measure of syllabic intensity as major components. Other aspects,


such as sentence structure, graphic presentation, and font types may influence readability; yet, these are very subjective in character and really complex to measure.

Accepted readability indexes comprise the Flesch Readability Formula, given by Rudolf Flesch; the Fry Readability Graph, formed by Edward Fry; and the Gunning Fog Index, created by Robert Gunning (Lewis & Adams, 2001).8

George Klare (1963)9 describes readability as “the ease of understanding or comprehension due to the approach of writing.” This definition is based on writing style as taken apart from issues such as content, logic, and organization. Similarly, Gretchen Hargis and her colleagues at IBM (1998) acknowledged that readability, the “ease of reading words and sentences,” is a trait of simplicity.

The inventor of the SMOG readability formula G. Harry McLaughlin (1969)10 describes readability as: “the extent to which a specified class of public find certain reading material convincing and understandable.” This definition focuses the communication between the text and a class of readers of known character such as reading skill, prior knowledge, & motivation.

Edgar Dale and Jeanne Chall’s (1949)11 definition may be the most inclusive: “The sum (including all the interactions) of all those basics within a known portion of printed material that influence the success a group of readers have with it. The success is the level to which readers understand it, read it at a best possible speed, and find it appealing.”

1.3 READING GRADE LEVEL MEANING
The reading score level allocates to a manuscript depends on the use of the text. If the reading material is used for independent, unassisted, or recreational reason, the reading score

level will be more than a text intended for classroom use and finest learning gain. In other words, the similar text will be easier for the one with sophisticated reading skills (with a higher grade level) and difficult for those with less (and with a lower grade level).

The rating of highest education does not signal one’s reading level. High-school graduates read at the 9th-grade level, which means a huge number reads lower than that level. Those who pursue special sphere of knowledge may have higher levels of reading skill in those areas than they have for common reading. Thus, college graduates, who prefer to read general texts at the 10th-grade level, might desire more difficult texts in respect to their own specialty. Students who are poor readers of general classroom matters are often able to master complicated subjects that appeal to them.

Readability formulas measure certain characteristics of text which is based on mathematical calculations. These formulas are normally based on a semantic factor (the difficulty of words as per their length in characters or syllables) and other one syntactic factor (the difficulty of sentences as per their length in characters or words). So, not all factors that endorse readability can be calculated mathematically and these arithmetical equations cannot measure comprehension in a straight line. Therefore, readability formulas are measured to be predictions of reading ease but not the only method for computing readability. As mentioned previously readability formulas are being increasingly used to measure the understandability of written information in industrial sectors. (DuBay, 2004)\textsuperscript{12}

1.4 READABILITY FORMULAS

In the 1920s, educators found a method to use vocabulary difficulty and sentence length to forecast the complexity level of a text. They fixed this method in readability formulas, which have recognized their value in over 80 years of use.

Developments and research on the formulas was something of a undisclosed until the 1950s. Authors like Rudolf Flesch, George Klare, Edgar Dale, and Jeanne Chall developed the formulas and the research supporting them and their application. The formulas were largely used in journalism, research, health care, law, insurance, and manufacturing industry.

During 1980s, there were 200 formulas and about a thousand studies published on the readability formulas confirming to their strong theoretical and statistical legality. Research in due course established that the two factors commonly used in readability formulas—a semantic (meaning) variable such as difficulty of vocabulary and a syntactic (sentence structure) variable such as average sentence length—are the best interpreter of textual difficulty. (DuBay, 2004)\textsuperscript{13}

A lot of the critics were honestly anxious about the restrictions of the formulas and some of them presented alternatives such as usability testing. The substitutes of formulas are helpful but they were not able to do what the formulas do.

The Flesch readability formula is the most accepted measure for reviewing textual difficulty (Clatworthy & Jones, 2001)\textsuperscript{14}. This formula, devised in 1948, has received criticism for the reason that it has narrow focus and because of differing use of language since it was first devised. Despite of the limits, the Flesch readability formula offers an objective evaluation of reading ease (Subramanian et al., 1993)\textsuperscript{15}

Fog Index from computational linguistics is based on syntactical textual traits (like words per sentence and syllables per word). The intuition of using fog index is that, other things being equal, more syllables per word or more words per sentence make a text harder to read. Developed by Robert Gunning, the formula is an acknowledged and simple parameter for


assessing readability. After assuming that the script is well formed and logical, it confines text difficulty level as a function of syllables per word and words per sentence.

Still, it is actually very difficult to assess the words load/word length, and in result, other readability formulas such as Kincaid, Automated Readability Index (ARI), Coleman-Liau, Flesch Index, Lix, and Simple Measure of Gobbledygook (SMOG) Grading, have been created (Hossain and Siddiquee, 2008)\textsuperscript{16}. As per Courtis (1998)\textsuperscript{17}, readability formulae are the quantitative technique of foreseeing whether the target addressees are able to read the written text. This can be seen in the Flesch readability formula that includes two important variables that show its effect on the style of writing: sentence length and word length (Flesch, 1960)\textsuperscript{18}. The Flesch Formula remains the most accepted formula used in readability studies such as those of Courtis (1998), Hossain and Siddiquee (2008), and Smith et al. (2006)\textsuperscript{19}, primarily because it is easy, rapid, and simple to apply.

Most readability metrics confine fundamentally the same linguistic phenomena—number of words per sentence and number of syllables per word—and vary only with respect to the load assigned to each. Preceding studies on the readability of annual reports have either used the Chairman’s Statement (Courtis, 1998; Smith et al. 2006), Management Review (Hossain and Siddiquee, 2008), Management Discussion and Analysis (Schroeder and Gibson, 1992)\textsuperscript{20} and Letter to the Stockholders (Subramanian et al., 1993)\textsuperscript{21}. Most of these research work used readability formulas, particularly the Flesch readability formula, as a calculation of

\begin{itemize}
  \item \textsuperscript{18} Flesch, R.F. (1960). \textit{How to write, speak and think effectively}. New York, Harper and Row; 305–353
  \item \textsuperscript{20} Schroeder, N. & Gibson, C. (1990). “Readability of management’s discussion and analysis”. \textit{Accounting Horizons} 4(4), 78–87
\end{itemize}
readability. Following is the list of some of the readability scores measured in this study which are explained further in the thesis under the heading of Research Methodology:

- Flesch Kincaid Reading Ease
- Flesch Kincaid Grade Level
- Gunning Fog Index
- SMOG Score
- Coleman Liau Index
- Automated Readability Index

2. CORPORATE DISCLOSURES

2.1 UNDERSTANDING CORPORATE DISCLOSURES

Corporate Governance plays a vital role in shielding the interest of various shareholders in capital market. Over time, there have been rising social, political, and economic pressures on corporate to pay greater attention to the extensive social and environmental consequences of corporate actions in decision-making procedure (Spicer, 1978)\(^{22}\). The increasing demands for clarity in information and hard facts about the corporate performance by an increasingly well-informed class of stakeholders have made corporate disclosure an important issue of debate. Also, recent industry scandals and fraud cases have also added to the progressively more importance of corporate reporting practices. Corporate scandals like of Enron, World Com at global level and frauds through promoters of Satyam computers and Global trust bank in India have unwrapped the eyes of shareholders and now investors are becoming vigilant day by day while making investments in stock market. Securities Exchange Board of India also making continuous attempts to protect the interest of shareholders by way of strengthening the corporate governance rules by asking companies for progressively disclosure of information on the working in financial statements of companies. To secure the investment, now investor has to be very cautious and attentive before investing in any corporation, for that concern investor has to check the promoters of the company and also observe the corporate governance.

governance practices accessible in that corporation and notice that the disclosure practices are
us per directives by clause 49 of listing agreement. (Bhanumurthy & Dessai, 2010)23

Disclosure of information in annual reports of corporate and its determinants have been
recognized as an important research area and have involved both analytical and empirical
researchers in finance since the 1970s. In the late 1990s, the Athens stock exchange
experienced major development as a promising capital market. Its position was upgraded by
international investment funds in 2000 as a developed capital market. Conversely, the market
fell notably in 2000 and has subsequently showed only partial recovery. Under these
circumstances, corporate financial reporting has been under the limelight of regulators,
investors and the media, and there has been even more demand for greater transparency and
superiority in corporate financial communications with shareholders. (Galani, Alexandridis,
& Stavropoulos, 2011)24

2.2 CONTENTS OF CORPORATE DISCLOSURES:
Corporate disclosure is projected to provide information on the operating activities, and the
financial and business condition of a firm to a concerned audience. Firms’ disclosure is for
that reason not restricted to financial information, but also addresses a great range of non-
financial information.

The content of major corporate governance policy and regulations with a spotlight on
financial disclosures, a series of non-financial disclosures, disclosures related to general
meetings, the timing and ways of disclosures and the disclosure of the level of compliance
with codes of corporate governance are explained underneath. Corporate disclosure contains

2.2.1 Financial Disclosures:

http://ssrn.com/abstract=1686650
Characteristics and Corporate Mandatory Disclosure the Case of Greece”. World Academy of Science,
Engineering and Technology (77), 101-107
One of the chief responsibilities of the board of directors is to make sure that shareholders and other stakeholders are presented with high-quality disclosures on the financial and operating results of the firm that the board of directors has been assigned with governing. Nearly all corporate governance codes around the world, including the OECD and the ICGN Principles, the CACG Guidelines, particularly require the board of directors to supply shareholders and other stakeholders with information on the financial and operating results of a company to facilitate them to suitably understand the nature of its dealings, its existing state of affairs and how it is being planned for the future. The quality of financial disclosure is based on considerably on the robustness of the financial reporting principles on the basis of which the financial information is arranged and published.

2.2.2 Non Financial Disclosures:

- **Company’s Objectives**: The objectives of enterprises may differ according to the standards of society. In many nations, the primary purpose of corporate is to maximize the long-term return to shareholders (value of shares hold by the shareholders). This aim appears in many regulations throughout the world. Many new principles now include social, environmental and economic objectives as a fraction of the fundamental objectives of a firm. The codes specifically stress the need for enterprises to attend to the interests of a variety of stakeholders in order to encourage the long-term sustainability of the company.

- **Ownership & Shareholder’s Right**: It is of immense importance in an investment decision, particularly with regard to the fair treatment of shareholders. In order to inform about a decision of the company, investors need access to information concerning its ownership structure. It is suggested that this disclosure comprises the attention of shareholdings, for instance the holdings of the top twenty largest shareholders.

- **Changes in Control and Transactions Involving Significant Assets**: Finest practice suggests a substantial quantity of pre-control transaction disclosure, comprising the disclosure of the purpose to acquire control, and to take the enterprise private, and of associated squeeze out/sell-out rights applicable for minority shareholders.

- **Governance Structures & Policies**: The composition of the board should be revealed, in particular the no. of executives and non-executive directors, and whether any of the non-executives have any associations (direct or indirect) with the company.
• **Material Issues Regarding Stakeholders, and Environmental and Social Stewardship:** The board should disclose its plan and performance in connection with environmental and social accountability and the impact of this plan and performance on the firm’s sustainability.

• **Material Foreseeable Risk Factors:** The board should give suitable disclosures and assurance concerning its risk management objectives, systems and actions. The board should disclose existing provisions for recognizing and managing the effects of risk bearing actions. The board should report on internal control systems designed to mitigate risks. Such reporting should include risk identification mechanisms.

• **Independence of External Auditors:** The board should disclose that it has assurance that the external auditors are autonomous and their competency and reliability have not been compromised in any case.

• **Internal Audit Function:** Enterprises should disclose the extent of work and tasks of the internal audit function and the highest level within the management of the enterprise to which the internal audit function works. Ventures with no internal audit function should disclose the reasons for its nonexistence.

• **General Meetings:** Disclosure should be made of the procedure for holding and voting at annual general meetings and unexpected general meetings, as well as all other information needed for shareholders to contribute effectively in such meetings. Announcement of the agenda and planned resolutions should be made in a judicious fashion, and be made available in the national language (or one of the official languages) of the venture as well as, if suitable, an internationally used business language. The results of a general meeting should be communicated to all shareholders as early as possible.

• **Good Practices for Compliance:** Where there is a national code on corporate governance, firms should follow a “comply or explain” rule whereby they reveal the extent to which they pursued the local code’s recommendations and clarify any deviations. If the country do not have local code on corporate governance, companies should pursue recognized international good governance policies. All material issues connecting to corporate governance of the enterprise should be disclosed in a sensible fashion. The disclosure should be comprehensible, brief, and precise and directed by the “substance over form” principle.
As financial reporting and revelation are potentially significant means for management to converse firm’s performance and value to external investors, enlarged disclosure practices will help in reducing information space between firm and its stakeholders. The main reason behind importance on this new budding issue is that improved disclosure and clearness are the twin cornerstones for shielding shareholder’s right. Full disclosure practice along with simplicity in financial reporting can build an atmosphere of trust and enhance confidence of investors’ community. (Madhani, 2008)

2.3 ANNUAL REPORT: A Disclosure

The corporate annual report contains gathered corporate information about growth and events that occurred during the reporting year in a complete and condensed manner, which are formed on a regular basis and offer an opportunity for a comparative analysis of organization attitudes and policies across reporting periods (Niemark, 1995). It is normally perceived to be the most important business report for company evaluation. It provides opportunities for firms to increase their communication with investors and the financial group of people in general by going further than the reporting of merely financial information (Cameron and Guthrie, 1993). Marston and Shrives (1991) concluded that the annual report is the broadest document available to the public and is therefore the main disclosure medium. Parker (1982) highlighted the significance of annual reports as a mass communiqué medium, which emphasizing its broad coverage and availability. It is also supposed to be the main external reporting vehicle for information announcement (Johanson et al., 1999). For these reasons, the corporate annual report is chosen for the purpose of this research.

3. ENVIRONMENT OF FINANCIAL REPORTING IN INDIA

At present India is extensively considered as a latest growing country and an important participant in the universal economy. The economy of India is at fourth position in the world as measured by Purchasing Power Parity (PPP), having Gross Domestic Product (GDP) of US$3.611 trillion. Over the past two decades, changes in financial and reporting regulations have significantly increased the amount of required disclosures by firms to external users. In addition, technological advancement and new developments in financial engineering have made it more challenging for firms to communicate information about the underlying fundamentals of their businesses in a clear and informative manner. The increase in the amount of required disclosure accompanied by the challenging task of communicating increasingly complex business transactions to investors has led to concerns about the effectiveness of management communication and the ability of interested users to make informed decisions based on this information. (Lehavy, Li, & Merkley, 2011)31

There are two professional bodies working in India, these being, the Institute of Chartered Accountants of India (ICAI), and the Institute of Cost and Works Accountants of India (ICWAI). Indian companies follow accounting practices which comes from Accounting Standards created by the ICAI, and till date, 28 standards are been implied in India. As per the ICAI, India is significantly in complying with the International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA). In India ICWAI is considered as only acknowledged statutory professional body and licensing organization specialized in Cost and Management Accountancy.

Listed companies must meet the terms with the set of laws prescribed by the Securities and Exchange Board of India Act 1992. Undeniably, as per the Company Act, organization must clarify any discrepancies in the financial statements if any from the prearranged accounting standards. The SEBI examines and standardize corporate governance companies which are listed ion Indian Stock Exchanges under Clause 49. The clause 49 is included in the listing

contract between stock exchanges & companies and companies have to comply with its provisions compulsorily. Under the Clause, there are requirements for separate sections in the Annual Reports of firms like corporate governance, Auditor’s Report etc in order to have a detailed report on working of the organizations. The corporate governance report contains nine sections dealing with the board of directors, audit committee, remuneration of directors, shareholders’ grievance committee, general body meeting (board procedure), disclosure of related parties, means of communication, general shareholders’ information, others including risk management, management discussion and analysis, information and compliance respectively. Company must get a certificate from the auditors or practising company secretaries on the subject of fulfillment of conditions of annual reports as set in the clause 49, and enclose the certificate with the directors’ report, which is sent yearly to all the shareholders of the organization. The same certificate is also sent to the Stock Exchanges along with the annual report prepared by the company.

The Indian financial system is distinguished by a huge network of commercial banks, financial institutions, stock exchanges, and a broad series of financial instruments (Agarwal, 2000)\textsuperscript{32}. A document was released by the Basel Committee on Banking Supervision (henceforth Basel) entitled ‘Enhancing Bank Transparency’ (BASEL, 1988)\textsuperscript{33}, in regard to transparency to be a vital element of an successfully supervised, regulated and sound banking system and proposes that commercial banks, in regular reporting of financial statements and other public disclosures, makes well-timed information which assist market participants’ judgment of banks. Therefore, sufficient public disclosures aid a more well-organized distribution of capital in banks, since it helps out the market to precisely evaluate and compares the risk and return prediction of individual banks.

The financial reporting and disclosure of banks in India are regulated by the Companies Act 1956, the Banking Regulation Act 1949, the rules of the Securities and Exchange Board of India (hereafter SEBI), and the guidelines of the Reserve Bank of India (hereafter RBI), as


well as the recommendations of the Institute of Chartered Accountants of India (ICAI). The Banking Regulation Act 1949 provides a framework for regulation and supervision of commercial banking activity. Section 29(1) of the Banking Regulation Act 1949 states that at the expiration of each calendar year, every banking company shall prepare a balance sheet and profit and loss account, in the forms set out in the Third Schedule Form A and Form B of the Act respectively. Section 30(1) states that the balance sheet and profit and loss account should be prepared in accordance with Section 29 and audited by a person duly qualified under law. Section 31(1) also states that the accounts and balance sheet, together with the auditor's report, shall be published in the prescribed manner and three copies thereof shall be furnished as returns to the RBI within three months from the end of the period. Section 32 requires that three copies of the accounts and balance sheet, together with the auditor's report, should be sent to the Registrar of Company Affairs.

The RBI is committed to enhancing and improving the levels of transparency and disclosure in banks’ annual accounts. The Reserve Bank Act 1934, and the Banking Regulation Act 1949 invested the RBI with wide powers of supervision and control over commercial banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. Consequently, it is authorized to carry out periodical inspections of the banks and to call for returns and necessary information from them.

4. SIGNIFICANCE OF DISCLOSURE DOCUMENTS IN ACCOUNTING RESEARCH

Listed companies prepare annual reports for a diverse group of users (such as shareholders, regulatory bodies, employees, and other interested parties) with the intention to communicate their financial information. That communication is central to the accounting function was succinctly stated by Littleton and Zimmerman (1962)\(^{34}\). Now an issue of research interest is to test whether the degree to which accounting information contained in these reports are understood and conveyed the exact meaning intended by their senders.

The disclosure-related literature has developed into a distinct branch of economic and accounting research (Frolov, 2004)\(^{35}\). Following the taxonomy suggested by Verrecchia (2001)\(^{36}\), it is easy to distinguish three major research problems confronted by the literature.

i. Whether information disclosure is economically efficient in general;

ii. The effect of information disclosure on the aggregate behavior of economic agents;

iii. The circumstances surrounding the decision to make private information public.

Firstly, researchers have sought answers to the general question about whether information disclosure is economically efficient in general. In this respect, two theorists suggest differing explanations for the per-se desirability of information disclosure. On the one hand, Kunkel (1982)\(^{37}\) shows that in an economy including both production and exchange, information disclosure may be preferred because altered production plans lead to more efficient allocation of resources across time and firms. On the other hand, Diamond (1985)\(^{38}\) also suggests that in a pure exchange setting with costly acquisition of private information, the (costless) information disclosure is desirable because it will allow investors to have an added advantage on the acquisition of private information and make them better off, despite adverse risk-sharing effects. Secondly, the literature on disclosure-related research focuses on the effect of information disclosure on the aggregate behavior of economic agents, and in particular on the behavior of financial market aggregates like stock prices and trading volume. It is a standard argument here that management’s decision about whether to disclose information or not is based on weighing expected costs and benefits of making the information public (Frolov, 2004). The available literature has suggested many ways that a firm or its management can benefit from improved disclosure. For example, direct evidence that firms increase the intensity of their disclosure efforts before offering public debt and equity has been obtained by Frankel et al. (1995)\(^{39}\).

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37 Kunkel, G. (1982). “Sufficient Conditions for Public Information to have Social Value in a


Indeed, the Extent of Disclosure in Annual Reports of Banking Companies: The Case of India economic and accounting literature has asserted that in the view of informational asymmetry, (costless) disclosure of private information brings general gains in economic efficiency. However, the size of the gains and the ultimate effect on financial prices may vary considerably depending on the ‘informativeness’ of disclosed information and on the ways the information is disseminated and used. (Hossain, 2008)

5. RELEVANCE OF READABILITY IN CORPORATE DISCLOSURES

Late in 2009, in a London based periodical, journalist Christodouloua presented an interesting yet troubling article in which he reports:

“Companies have given up trying to make their annual reports readable according to Pricewaterhouse Cooper’s reporting; who believes over-regulation could be killing off good reporting. David Phillips, PwC’s senior corporate reporting partner, believes a box ticking culture has degraded annual reports to the point where they are, “legally compliant, but, as a communication document, dreadful” he said. “What the investors want is just good data and, if I’m honest, financial reporting today doesn’t give them that.”

Corporate annual reports are widely acknowledged as tools used by companies to facilitate communication with investors and other stakeholders. Annual reports are viewed as authoritative and legitimate documents, yet they are ones in which editorial control remains with those responsible for their preparation (Neu et al. 1998)

Readability of annual reports is naturally a topical area. These documents represent the primary source of information for investors and analysts for decision-making purposes. As such it is important that users are able to understand and comprehend the information contained within a company’s annual report.

The importance of the corporate annual report stresses its potential to be influential. It can either be a good news communication highlighting superior corporate performance or a bad news communication relating sub-par financial results or corporate actions. Firms that veil negative information are missing an opportunity to gain trust and confidence (Subramanian et al., 1993).

There are three significant elements of corporate disclosure: content (what), timing (when) and presentation (how) (Courtis, 2004), the worth of these three, is based upon their readability and understandability. Firms may influence the content and appearance of information in various ways, fundamentally using what is called as ‘impression management’ (Godfrey et al., 2003). Using the above practice, companies can manipulate oral information by the reading ease manipulation (e.g., to make the text difficult to read) or by the rhetorical manipulation method/practice (e.g., using persuasive language).

However, existing studies suggest that annual report text can be manipulated based on the type of information being conveyed. For example, Subramanian, Insley, and Blackwell (1993) found that annual reports for companies with good performance were easier to read (requiring a 10th grade level to read) than those with poor performance (requiring at least a 14th grade level or a college education). Furthermore, in their analysis of annual reports, Straw, McKechnie, and Puffer (1983) found that managers took credit for good news and blamed the environment for bad news.

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As mentioned previously, annual report readability has undergone scrutiny. With the SEC and the investing community calling for improved corporate disclosure, annual reports must be readable. Firtel (1999)\textsuperscript{47} has identified that the US Securities and Exchange Commission (SEC) has made consistent efforts to make the disclosure documents of public companies more readable. One such effort is the Plain English Disclosure Handbook, adopted by the SEC on January 22, 1998 which shows how to use well-established techniques for writing in plain English to create clearer and more informative disclosure documents (US Securities and Exchange Commission, 1998). The underlying argument for the plain English disclosure regulation is that (1) firms could use vague language and format in disclosure to hide adverse information, and (2) the average investors may not understand complex documents and this could result in capital market inefficiency.

On the contrary, the relevance of the regulation, however, is not straightforward. First, there are other information sources (such as financial analyst reports) for investors. Depending on whether the different information sources are complements or substitutes, annual report readability may or may not be relevant. Second, some critics contend that disclosure should primarily be geared towards sophisticated investors due to the complicated nature of technical and financial information (Firtel 1999). Finally, to the extent that the marginal investors are sophisticated and understand complex disclosure, stock price may not be distorted even if complicated language and format are used.

In an informational efficient world characterized by perfect capital markets, strategic disclosures by management designed to obfuscate the firm’s true financial performance would be readily identifiable, easily dismissed, and thus irrelevant to security prices. Similarly, to the extent corporate disclosures represent significant news events for firms, undetected management reporting biases would not necessarily impact the ex-ante market valuation of individual securities if information risk is completely diversifiable. By contrast, if disclosure opacity is capable of altering either (1) the expected levels/timing of future cash flows, or (2) the required opportunity rate used to discount expected cash flows, then firm pronouncements may well be associated with managerial incentives to window dress

financial disclosures in order to favorably influence the market pricing of the firm’s securities. (Dempsey, Harrison, Luchtenberg, & Seiler, 2010)⁴⁸

Many researchers have recommended that the audience and level of sophistication of users be considered when preparing corporate annual report narratives (Smith and Taffler, 1992)⁴⁹. A corporation generally prepares annual reports knowing that a diverse range of stakeholders will constitute the user and readership group of those reports. The level of sophistication of these users will vary from unsophisticated private investors to very sophisticated users such as stockbrokers and financial analysts. Low reading ease in narrative sections of corporate annual reports potentially disadvantages unsophisticated users. A point to note is that unsophisticated users of corporate annual reports generally have access to sophisticated analysts such as stockbrokers to aid in their understanding of the content and consequent investment decision-making. (Jones, 1988)⁵⁰

However, more readable narratives could aid in preventing unsophisticated users from having to incur the associated costs. Although investment decisions are unlikely to be involved, unsophisticated users of reports are unlikely to have access to more sophisticated third parties to aid in deciphering appropriate meaning from narratives. The expected audience of the annual reports includes the general public. The general public would typically be the greatest of these user categories in terms of the potential number of users of an annual report. A high percentage of the general public would be likely to be considered unsophisticated in terms of their understanding of accounting information and narrative disclosures in annual reports, potentially placing them at a disadvantage if such reports exhibit low reading ease. However, readers are more likely to persist when a document is more readable (Nale, Rauch and Barr 1998)⁵¹.

Conclusion: Still the area of research for readability of annual reports of Indian companies in connection with financial performance is been left out. The research work is an initiative to test the relationship of readability levels of annual reports of banking sector with their performance figures. Hence this study may reveal whether corporate communication in the form annual reports could reduce information asymmetry or not. If disclosure readability is strategically used by managers to hide adverse information, a relationship between firm performance and readability would be expected. There are many prior studies investigating the relationship between the readability of the corporate narrative and firm performance, and hence this study is motivated to test some of hypotheses that have been developed in this respect. The variables that represent the firm’s financial performance are profitability, liquidity, leverage, ROA and size. So it is essential to study the readability scores of annual reports and to verify its relation with some of the important parameters which can make significant change in their readability scores. The thesis covers the annual reports of banking sector in India and compares the readability scores of these reports on the basis of above mentioned independent variables.