



Manager's narratives in the board of director's report to the annual general meetings: Is it thoughtful?

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ABSTRACT

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This paper evaluates the difference between the narratives of the board of directors' report to the annual general meetings (AGM) and financial statements' numbers through content analysis using the approach developed by Balata and Breton (2005) _ the index of level of optimism. This paper investigates that whether manager's narratives is thoughtful. The sample includes 40 reports that are downloaded from CODAL website. We conclude that from point of profitability, there is a difference in the degree of optimism for narrative parts and financial statements in the low optimism and aggressive optimism companies and there is thoughtful communication in their narrative reports. From growth point of view, in low optimism and passively optimism companies, there is no thoughtful communication. Good performing companies tend to show a better picture of growth to shareholders. Results of management theme and its related financial ratios revealed that there is a significant difference in low optimism and passively optimism companies, but not in aggressive optimism ones. These ones are consistent with real world expectations. Managers always want to outline a good picture of themselves to market. Totally, our conclusions verify a thoughtful communication in a narrative parts of annual reports.

Keywords:

Content analysis, Annual reports, Narrative, Thoughtful communication, AGM

1. Introduction

Typically, an annual report contains financial and non-financial sections. The non-financial sections include explanations and interpretations (Abrahamson and Amir, 1996), which are not audited and not regulated which are called accounting narratives (Pawel Zakrajewski, 2011; Clatworthy Mark, Jones Michael John, 2003). Breton (2009) argues that accounting studies focus more and more on the narrative sections of the annual report which are often considered to be the principal means through which the financial information is disseminated to investors. These reports may thus constitute a significantly different and complementary information source to that of the numerical financial statements (Smith and Taffler, 1995). Later in 2000, they show that chairman's statement is closely associated with financial performance, reinforcing the argument that such unaudited disclosures contain important information (Smith and Taffler, 2000). Pawel Zakrajewski (2011) suggest that a letter to shareholders may function as one of the tools of communication between companies throughout the world. This part of annual reports is free to select and present the information included in it (Geppert and Lawrence, 2008) and allows management to provide users with potentially useful information not included in the financial statements and no specific requirements or regulations exist as to what should be included in the president's letter to shareholders (Abrahamson and Amir, 1996). As agreed by Clatworthy and Jones (2006), the chairman's statement (also known as the president's letter) is an almost universal, and widely read, feature of the annual report. It is used to provide an overview of the company's activities and performance during the year. There is evidence that the content of the chairman's statement affects investors' decision-making, and potentially corporate value (Clatworthy and Jones, 2006). For these reasons, the focus of this paper is on president's letter.

As mentioned earlier, a letter to shareholders is a part of an annual report and is categorized as accounting narratives. This paper aims to add to the knowledge of accounting narratives in Iran. In Iran, a letter to shareholders or the letter of a Chief Executive Officer of a company to its shareholders, is known as the board of directors' report to the annual general meetings (AGM). It mainly includes CEO' message to

shareholders, general information about company, review with specific information about the company's performance over the past fiscal year, related-party transactions, information about board of directors, independent audit and legal inspector information, risk analysis, social and human resources information, R&D expenses, dividend policy.

The above quotes suggest that the board of directors' report to the AGM should be of great importance for Iranian shareholders. So the purpose of this paper is to measure the CEO's message and compare it to financial statements. This study is the first to look at the board of directors' report to the AGM from Iranian companies. As such, it extends prior research into accounting narratives.

The research question addressed in this paper asks: do managers narrative thoughtfully to shareholders? To answer this question, we investigate if there is difference in the content of the board of directors' report to the AGM and financial statements? This study uses content analysis. We build on Balata and Breton (2005) index of the level of optimism to demonstrate if there is difference between the messages of board of director's report to the AGM and financial statements. This study follows central themes used in Breton and Taffler (2001), Balata and Breton (2005) to examine the content of the board of director's report to AGM.

The remainder of the paper proceeds as follows. The next section provides literature review and develops hypothesis. Section three expresses research methodology. It explains content analysis, sample selection. In section four, we explain research findings and results. At last, in section 5, we draw conclusions.

2. Literature Review and Hypothesis Development

2.1. Literature Review

In accounting, the studies focus more and more on the narrative sections of the annual report, arguing that the report, as a whole, is the vehicle of the financial statements which are often considered to be the principal means through which the financial information is disseminated to investors (Breton, 2009). Accounting narrative research has a long pedigree stretching back to the 1970s. One of the main streams in a comprehensive overview of the then extant literature is content analysis studies (Jones and

Smith, 2014). The content analysis studies were more varied in their scope and methods. One principal issue can be identified as the correlation between narrative disclosures and financial reporting. In the content analysis literature, a number of studies find an association between accounting narratives and financial performance (Beynon, Clatworthy and Jones, 2004).

Kohut and Segars (1992) examine the content of president's letters of high and low performing firms. They suggest that financial performance influences the manner in which CEOs report annual corporate results (Kohut and segars, 1992). Abrahamson and Amir (1996) evaluate and measure the textual information contained in the president's letter to shareholders through content analysis. They suggest that the president's letter contains useful information about the future of the company and not just about past performance. They emphasize the importance of non-financial information (Abrahamson & Amir, 1996). Balata and Breton (2005) conduct a content analysis of the president letter. Their results indicate a moderate level of divergence between the narrative sections and the accounting data (Balata and Breton, 2005).

Clatworthy and Jones (2006) assess the effect of financial performance on the textual characteristics of the chairman's statement. They indicate that the chairman's statement is subject to impression management techniques (Clatworthy and Jones, 2006). Bhana (2009) analyses the chairman's statements of the top 50 and bottom 50 companies listed on the JSE and finds that companies show a preference to emphasize the positive aspects of their performance. Managers use accounting narratives in a self-serving manner, rather than reporting performance objectively (Bhana, 2009). Hooghiemstra (2010) using content analysis on 400 Letters, found that CEOs use this opportunity to portray the company in the best possible light. Schleicher and Walker (2010) employ content analysis technique and find that firms with large impending performance declines bias the tone in the outlook section upwards; loss firms, risky firms and firms with analyst earnings forecast provide a more positive tone, while firms with an earnings decline provide a more negative tone.

2.2. Hypotheses

In sum, the prior literature shows that the content of board of director's narratives is potentially

indicating CEO's preferences. It might be expected that both high and low performance companies will be associated with optimistic message through a positive executive narrative. We predict that CEO's narratives to the AGM is thoughtful. We hypothesize that these narratives are different from financial statements' message. This discussion leads to the following hypotheses:

H1: CEO's narratives in the board of director's report to the AGM is different to the ones in the financial statements.

We test H1 around three central themes:

H1a: The degree of optimism of profitability in the board of director's report to the AGM will be significantly higher than the degree of optimism derivable from the numbers in the financial statements.

H1b: The degree of optimism of growth in the board of director's report to the AGM will be significantly higher than the degree of optimism derivable from the numbers in the financial statements.

H1c: The degree of optimism of management quality in the board of director's report to the AGM will be significantly higher than the degree of optimism derivable from the numbers in the financial statements.

3. Methodology

3.1. Content Analysis

Content analysis is defined as a method that uses a set of procedures to make valid inferences from texts (Smith, 2003) and is a widely used qualitative research technique to analyze text data (Hsieh, Shannon, 2005). Researchers regard content analysis as a flexible method for analyzing text data (Cavanagh, 1997). The use of word frequencies is described by Weber (1990) in his text on content analysis. The goal of content analysis is "to provide knowledge and understanding of the phenomenon under study" (Downe-Wamboldt, 1992, p. 314). All approaches to qualitative content analysis require a similar analytical process of seven classic steps, including formulating the research questions to be answered, selecting the sample to be analyzed, defining the categories to be applied, outlining the coding process and the coder training, implementing the coding process, determining trustworthiness, and analyzing the results of the coding process (Kaid, 1989).⁶

Content analysis is one method for analyzing narratives (Balata and Breton, 2005). Balata and

Breton (2005) state that as many words transfer the same idea, themes are used to grasp at once one concept represented by a series of words. We use meaning orientated (theme based) content analysis method and follow the themes profitability, growth and management as Smith and Taffler (2000), Breton and Taffler (2001), and Breton and Balata (2005) argue as the main factors in evaluating the perspectives of a firm. Each theme represents a series of words and roots. The used words are listed in appendix 1 in English.

Profitability includes words explaining the level of the firm's profitability and expectations of management toward it. Growth expresses the possibility for expanding firm's activities, to open new markets and to launch new products and services. Management contains observations about the strategies they implement and quality of the management in place (Balata and Breton, 2005).

3.2. The Sample

To test the hypothesis, we download all the publicly-held corporation's board of director's report

to the AGM from CODAL.IR website that their fiscal year were in March 2014. All the files were in PDF format. We then check these reports if these reports are scanned or not. The scanned files were removed because the "find" item on such PDF files are not working. We need "find" item to count occurrence of each word correctly. Totally 40 reports are selected. Because the sampled firms do not cover many companies, all the industries are analyzed entirely. The size of the sample does not permit to discuss conclusions for any particular sector.

Actually all selected files counted by a third person again to assure the correctness of word occurrences. Using computer programs is the common method to index English texts. But these softwares in Iran are introduced recently and are not complete. Therefore, we prefer to use computerized and manual method. We open each report and after finding each word, we read the whole sentence to attribute one of the positive, neutral or negative value to that word. We repeat this manner for all the words in all the selected files.

Table 1- Financial measures and their calculation and criteria for the attribution of the values

| Themes | Financial Ratio | Values | Criteria |
|--|--|-----------|---|
| Profitability | Rate of Return on Equity (RRE) = $\frac{\text{Profit Before Extraordinary Items}}{\text{Equity}}$ | Optimist | RRE > 0 and $\Delta\text{profit}_{(t,t-1)} > 0$ |
| | | Neutral | RRE > 0 and $\Delta\text{profit}_{(t,t-1)} < 0$ |
| | | Pessimist | RRE < 0 |
| | Variation of the Accounting Profit (VAP) = $\frac{\text{Profit}_t - \text{Profit}_{t-1}}{\text{Profit}_{t-1}}$ | Optimist | VAP > 0 |
| | | Neutral | VAP = 0 |
| | | Pessimist | VAP < 0 |
| Working Capital Ratio (WCR) = $\frac{\text{Short term Assets}}{\text{Short term Liabilities}}$ | Optimist | WCR > 1 | |
| | Neutral | WCR = 0 | |
| | Pessimist | WCR < 0 | |
| Growth | Variation of Total Fixed Assets (VTFA) = $\frac{\text{TFA}_t - \text{TFA}_{t-1}}{\text{TFA}_{t-1}}$ | Optimist | VTFA > 0 and $\Delta\text{TA} > 0$ |
| | | Neutral | VTFA = 0 and $\Delta\text{TA} > 0$ |
| | | Pessimist | VTFA < 0 and $\Delta\text{TA} < 0$ |
| | Variation of Total Sales (VTS) = $\frac{\text{T Sales}_t - \text{T Sales}_{t-1}}{\text{T Sales}_{t-1}}$ | Optimist | VTS > 0 |
| | | Neutral | VTS = 0 |
| | | Pessimist | VTS < 0 |
| Management | Variation of Dividend (VD) = $\frac{\text{Dividend}_t - \text{Dividend}_{t-1}}{\text{Dividend}_{t-1}}$ | Optimist | VD > 0 and $\text{dividend}_t > 0$ |
| | | Neutral | VD ≤ 0 and $\text{dividend}_t > 0$ |
| | | Pessimist | VD < 0 and $\text{dividend}_t = 0$ |
| | Variation of Shareholder's Funds (VSF) = $\frac{\text{S F}_t - \text{S F}_{t-1}}{\text{S F}_{t-1}}$ | Optimist | VSF > 0 |
| | | Neutral | VSF = 0 |
| | | Pessimist | VSF < 0 |

In the second phase, we measure the financial ratios. At this point, we download the audited financial statements of selected reports for the fiscal year 2014-March. Although there were financial ratios available in websites, we personally calculated financial ratios to be certain about the results of our research. We calculated all the ratios in term of variation from the preceding year. Then exactly like in the case of the words, we attribute the ratios an/a optimistic, neutral or pessimistic value. Table 1 gives the measures, their formulas for each ratio and criteria for the attribution of the values. According to this basis, we now can contrast the effect made by the narrative section with the effect by the numbers.

4. Results

Total frequencies and frequencies broken for the themes profitability, growth and management for the entire sample are shown in table 2. This table also highlights the average and standard deviation of these themes. Content analysis generated different frequencies for the positive, neutral and negative categories, exerted on the report from the board of the

directors to the AGM. Among 40 analyzed reports, total frequencies for the profitability theme are 1922, and 37 percent of this theme is positive. For growth and management themes, the percentage of positive words is 50 and 53, respectively.

In order to test for differences between the means of the optimism of three themes, we carried out an overall analysis of variance (ANOVA) test. This showed that overall, the means of optimism between each theme and within themes were significantly different ($p= 0.000$). Table 3 shows the ANOVA results.

To fit data from content analysis on the level of their optimism, homogenous data was classified in same groups based on Ward index that was done by Balata and Breton (2005). Through a statistical procedure of automated classification applied to the board of directors' report to the AGM, we obtain three groups, homogeneous in term of their level of optimism. Table 4 shows the results of the classification. Appendix 2 shows the classified companies.

Table 2- Total frequencies and frequencies broken for each theme

| | Themes | | | | | | | | |
|---|---------------|---------|----------|----------|---------|----------|------------|---------|----------|
| | Profitability | | | Growth | | | Management | | |
| | Positive | Neutral | Negative | Positive | Neutral | Negative | Positive | Neutral | Negative |
| Frequencies broken for the qualified themes | 723 | 824 | 375 | 1003 | 771 | 204 | 583 | 462 | 47 |
| Total Frequency | 1922 | | | 1978 | | | 1092 | | |
| Percent | 37% | 43% | 20% | 50% | 40% | 10% | 53% | 42% | 5% |
| Mean | 18.075 | 20.6 | 9.375 | 25.075 | 19.28 | 5.1 | 15.575 | 11.55 | 1.175 |
| S.D. | 13.148 | 9.242 | 8.011 | 17.85 | 10.52 | 3.815 | 11.573 | 6.328 | 1.278 |

Source: authors' own research

Table 3- ANOVA results

| | | Sum of Squares | Df | Mean Square | F | Sig. |
|-----|----------------|----------------|----|-------------|---------|------|
| POP | Between Groups | 5445.896 | 2 | 2722.948 | 77.686 | .000 |
| | Within Groups | 1296.879 | 37 | 35.051 | | |
| | Total | 6742.775 | 39 | | | |
| GOP | Between Groups | 10630.108 | 2 | 5315.054 | 109.457 | .000 |
| | Within Groups | 1796.667 | 37 | 48.559 | | |
| | Total | 12426.775 | 39 | | | |
| MOP | Between Groups | 3286.473 | 2 | 1643.236 | 31.384 | .000 |
| | Within Groups | 1937.302 | 37 | 52.360 | | |
| | Total | 5223.775 | 39 | | | |

POP = Profitability Optimist
 GOP = Growth Optimist
 MOP = Management Optimist

Source: authors' own research

Table 4- Classification of the 40 reports in function of their level of optimism

| Groups | Degree of Optimism | | Textual Variables | | |
|---------------|---------------------|---------------|-------------------|--------------|--------------|
| | | | POP | GOP | MOP |
| Gr 1 n= 21 | Low Optimism | Mean | 8.1905 | 12.3333 | 6.4762 |
| | | S.D. | 4.0450 | 6.6358 | 3.4586 |
| | | Z Calculation | -2/4436491 | -1/920156268 | -2/341644695 |
| | | Significant | sign | Not sign | sign |
| Gr 2 n= 13 | Passively Optimism | Mean | 23.7692 | 30.0000 | 20.4615 |
| | | S.D. | 5.2306 | 6.4291 | 6.8388 |
| | | Z Calculation | 1/088641969 | 0/766048006 | 0/860755895 |
| | | Significant | Not sign | Not sign | Not sign |
| Gr 3 n= 6 | Aggressive Optimism | Mean | 40.3333 | 59.0000 | 30.1667 |
| | | S.D. | 11.3255 | 9.1652 | 15.0787 |
| | | Z Calculation | 1/965330418 | 3/701521121 | 1/034020882 |
| | | Significant | sign | sign | Not sign |

Source: authors' own research

In table 4, we see that the aggressive optimism (group 3) is encountered for all the profitability, growth and management variables, which shows that the optimism in this group is completely high. However, the largest number of firms is in the group one, where the level of optimism is quite low. This result may look contradictory with the table 3. In table 3, the positive words and optimism tone was dominant. In table 4, we see that this optimism is for a small number of companies (n=6). These results show that companies that are doing well, will present optimistic narratives.

Table 5 shows the means, standard deviations, Z calculations and its significance of the financial ratios.

Aggressive optimism group presents the best profitability situation among other groups. Therefore, at the first sight, the group one seems to have an optimistic message about profitability than other groups. The results about growth and management is not the same as profitability. Totally, the means of the financial ratios indicate that aggressive optimism companies are performing better than two other groups.

Finally, we have to consider both measures together to see if the message of management differs from the numbers in financial statements.

Table 5- Grouping of financial ratios in function of the three groups obtained through the content analysis

| Groups | Degree of Optimism | | Financial Variables | | | | | | |
|---------------|---------------------|---------------|---------------------|---------|---------|---------|---------|---------|---------|
| | | | RRE | VAP | WCR | VTFA | VTS | VD | VSF |
| Gr 1 n= 21 | Low Optimism | Mean | 0.3134 | 1.5090 | 1.5048 | 0.1300 | 0.3710 | 2.583 | 0.262 |
| | | S.D. | 0.5536 | 2.9309 | 1.1139 | 0.2259 | 0.4890 | 4.009 | 0.459 |
| | | Z Calculation | 0/1015 | 0/1119 | 0/1467 | -0/053 | 0/0492 | 0/1807 | -0/243 |
| | | Significant | not sig | not sig | not sig | not sig | not sig | not sig | not sig |
| Gr 2 n= 13 | Passively Optimism | Mean | 0.1227 | 0.269 | 1.0802 | 0.2885 | 0.2812 | 0.675 | 0.568 |
| | | S.D. | 0.9374 | 1.211 | 0.3032 | 0.5335 | 0.3982 | 0.600 | 1.080 |
| | | Z Calculation | -0/143 | -0/753 | -0/863 | 0/2745 | -0/165 | -1/971 | 0/1791 |
| | | Significant | not sig | not sig | not sig | not sig | not sig | sig | not sig |
| Gr 3 n= 6 | Aggressive Optimism | Mean | 0.3517 | 2.0100 | 1.3350 | -0.133 | 0.4050 | 1.885 | 0.347 |
| | | S.D. | 0.3645 | 3.372 | 0.2968 | 0.3893 | 0.2121 | 3.017 | 0.349 |
| | | Z Calculation | 0/25931 | 0/2458 | -0/021 | -0/707 | 0/2751 | 0/0087 | -0/079 |
| | | Significant | not sig | not sig | not sig | not sig | not sig | not sig | not sig |

Source: authors' own research

We have three themes: profitability, growth and management. The textual variable POP is compared with the corresponding ratios. For this one, we see for all three groups that the scores for the ratios are not significant, and significant for the first group and third group. Therefore, there is a difference in the degree of optimism for narrative parts and financial statements in the low optimism and aggressive optimism companies. Passively optimism companies do not show tendency to present more profitable picture than reality. Balata and Breton (2005) emphasize that profitability is the main target of accounting manipulations, so, it is perceived as the essential element having an influence on the general public and even on the sophisticated investors.

For the growth, there is no difference between the degree of optimism of the narratives and the financial statements information in the first and second groups (low optimism and passively optimism). For the third group, aggressively optimism, there is difference between narratives and numbers. It can be said that these companies expect future growth.

Balata and Breton (2005) believe that the quality of management is the key element for financial analysts in assessing investment opportunity that is seen everywhere in the financial statements. In this research, we have used two ratios to measure this quality. There is difference in the degree of optimism of the narratives and the financial statements information in the first group, low optimism. The other groups do not show any difference. These findings indicate that the managers of low optimism companies tend to show a better picture of the quality of their management rather to other companies. The managers of passively and aggressive optimism companies do not show a propensity to present a reassuring discourse.

5. Conclusion

This paper investigates the relation between narratives of the board of director's report to the AGM and the financial statements; it aims to explore that do managers narrative thoughtfully to shareholders? To do so, management narratives in the report of directors to the AGM analyzed from profitability, growth and management themes through content analysis. After content analysis, each theme tagged with optimistic, neutral and pessimistic. Then corresponding ratios of financial statements for these themes calculated and

each took a degree of optimism. There was a comparison between numeric results of those tags and ratios to find a possible difference on them.

Results on profitability showed that in companies with low optimism and aggressive optimism, there is a significance difference between narratives and their corresponding financial ratios. A possible reason for low optimism companies would be a desire to show good profitability situation to shareholders, but for aggressive optimism companies would need more investigation.

Findings on growth factor illustrated that in low optimism and passively optimism companies, there is no difference in the narratives and numbers. In other words, there is no thoughtful communication. But in aggressively optimism companies, there is difference. Good performing companies tend to show a better picture of growth to shareholders.

Results of management theme and its related financial ratios revealed that there is a significant difference in low optimism and passively optimism companies, but not in aggressive optimism. These ones are consistent with real world expectations. Managers always want to outline a good picture of themselves to market.

Finally, producers of financial statements are going to portray a picture in their report to the AGM that is different from the one in financial statements. We can say that a thoughtful communication and narrative exist in report from the board of directors to the AGM. Bhana (2009) found that managers use accounting narratives in a self-serving manner, rather than reporting performance objectively. Balata (2005) indicated a moderate level of divergence between the narratives sections and the accounting data. This study only takes one year reports. Further research may use different years and industries.

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Appendix 1- The themes and related key words

| Themes | Keywords | Positive | Neutral | Negative |
|----------------------|---------------------------------------|----------|---------|----------|
| Profitability | Benefit | | | |
| | Advantage(s) | | | |
| | Result(s) | | | |
| | Profit / Profitability | | | |
| | Return | | | |
| | Revenue | | | |
| | Expense(s) | | | |
| | Loss(es) | | | |
| | Cost / Spoilage / Waste / Scrap | | | |
| | Gain / Earnings | | | |
| | Price | | | |
| | Value | | | |
| | Sell | | | |
| | Production | | | |
| Liquidity / Cash | | | | |
| Growth | Growth | | | |
| | Market / Marketing | | | |
| | Strategy | | | |
| | Volume | | | |
| | Acquisition | | | |
| | Development / Design / Research | | | |
| | Restructuring | | | |
| | Investment | | | |
| | Modernization | | | |
| | Improvement(s) | | | |
| | Reorganization | | | |
| | Productivity | | | |
| | Efficiency | | | |
| | Quality | | | |
| | Diversification | | | |
| | Organizational agility | | | |
| Risk(s) / Volatility | | | | |
| Management | Management / Strategic Management | | | |
| | Manager | | | |
| | Competition / Competitor | | | |
| | Administration | | | |
| | Leadership | | | |
| | Initiative | | | |
| | Certificate(s) | | | |
| | Plan / Planning | | | |
| | Agent/ Agency / Representative | | | |
| | Brand | | | |
| | Information Transparency / Disclosure | | | |

Appendix 2- Sample clustered

| Clustered Companies | | |
|------------------------------------|-------------------------------------|------------------------------------|
| First Group of Clustered Companies | Second Group of Clustered Companies | Third Group of Clustered Companies |
| Electric-Khodro-Sharq | Pars-Khazar | Iran-Khodro |
| Pars-Switch | Pars-Khodro | Iran-Yasa |
| Petroshimi-Shiraz | Petroshimi-Khodro | Bahman |
| Daroosazi-Amin | Petroshimi-Abadan | Darooyi-Osveh |
| Rikhtehgari-Iran | Petroshimi-Shazand | Darooyi-Razak |
| Rikhtehgari-Tractorsazi-Iran | Pegah-Khorasan | Ringsazi-Mashad |
| Sorb-Rooy-Iran | Karkhanejate-Daroo-pakhsh | |
| Sarma-Afarin | Darooyi-Abooreyhan | |
| Siman-Bojnoord | Saipa-Diesel | |
| Siman-Behbahan | Siman-Tehran | |
| Siman-Karoon | Siman-Qarb | |
| Fanarsazi-Zar | Qashazar | |
| Gorouhe-Sanati-Automobile-Iran | Mehvarsazan-Iran-Khodro | |
| Qand-Qazvin | Naft-Behran | |
| Kashi-Sina | | |
| Cabon-Iran | | |
| Kimi-Daroo | | |
| Loabiran | | |
| Mehrkam-Pars | | |
| Mohandesi-Nasir-Machin | | |
| Nafte-Pars | | |