

Future-Oriented Narrative Reporting: Determinants and Use

Khaled Hussainey¹
Stirling University

and

Basil Al-Najjar
Middlesex University

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¹ Correspondence should be addressed to Dr. Khaled Hussainey, Accounting & Finance Division, Stirling Management School, University of Stirling, Stirling FK9 4LA, UK. Email: Khaled.Hussainey@stir.ac.uk.

ABSTRACT

Purpose: The purpose of this paper is to empirically examine the determinants for future-oriented information in the UK annual report narrative sections, in addition to empirically examining the association between levels of disclosure, as a proxy for asymmetric information, and corporate dividend policy.

Design/methodology/approach: We use tobit and logit regression models to empirically examine the association between levels of future-oriented information (the dependent variable) and firm-specific and corporate governance characteristics (the independent variables). We also use the same regression technique to investigate the association between dividend policy (the dependent variable) and levels of future-oriented information and other control variables (independent variables).

Findings: Our paper contributes to the disclosure studies in two crucial ways. First, it offers the first evidence that levels of future-oriented information is determined by firm size. Second, it offers the first UK evidence of the association between levels of corporate narrative reporting (as a measure of asymmetric information) and dividend policy. Our results show that dividends are positively related to corporate narrative reporting.

Practical implications: Our results suggest that UK companies use narrative reporting and dividends to signal their future prospects. Consequently, regulators should pay more attention to what is (and should be) reported in these narrative sections of the annual reports.

Originality/value: Judging from previous literature review, this paper offers the first empirical evidence to the drivers of future-oriented disclosure in the UK. The authors also aim to be the first to empirically examine the association between narrative reporting and dividend policy.

Keywords: Narrative reporting; Future-oriented information; Dividend policy; United Kingdom.

Classifications: Research paper

INTRODUCTION

Since the beginning of 1960s, numerous accounting studies have been devoted to investigate corporate financial disclosure. Many of these use the disclosure index and the manual content analysis approach to measure disclosure; others use subjective ratings like AIMR-FAF US analyst scores. Few among them, however, apply computer-based content analysis to study corporate reporting.

Hussainey et al. (2003) are considered among the first to investigate this issue in developed markets, in particular in UK. They have invested heavily in developing a new method for scoring a large sample on corporate narrative reports. Hussainey et al. contribute to the literature by using the Nudist software as well as the market based accounting research. They provide evidence that future-oriented information in annual report narratives contains value-relevant information for investors to better forecast future earnings. Their work is considered as one of the key factors allowing financial accounting research to move forward in the UK (Beattie, 2005).

In a recent study, Hussainey and Walker (2009) offer evidence that future-oriented information and dividend propensity are substitute forms of financial communication channels that UK high-growth firms can use for signalling value-relevant information to investors. For the sake of completeness, the present paper empirically examines what drives the future-oriented content of the UK annual report narratives. It also empirically examines the potential application of this class of information by UK firms in reducing agency costs.

We can consider at length the works of Hussainey et al. (2003) and Hussainey and Walker (2009) in the present paper for two main reasons. First, while future-oriented information has always been found to be useful for investors in the UK stock market, the nature of these scores is still unknown and what drives UK firms to voluntarily report this type of information in their annual report narratives. Second, Hussainey and Walker (2009) provide evidence that future-oriented information and dividend propensity are substitute forms for communicating value relevant information to investors. Their results are consistent with signalling theory, but not consistent with pecking order theory (Deshmukh, 2005). In addition, prior US research on the association between asymmetric information and dividends, such as Deshmukh (2003; 2005) and Li and Zhao (2008), still offer mixed results. Consequently, the association between dividend and levels of future-oriented information (as a measure of information asymmetry) remains a challenge and source of much debate. It is, therefore, one of the main issues to be empirically examined in the present paper.

Based on the above discussion, this paper contributes to two streams of research. First, this study adds to the growing research into determinants of corporate voluntary disclosure. Second, our paper contributes to the literature on the association between corporate disclosure policy and firms' dividend policy.

The paper is organised as follows. The next section reviews prior research and develops the research hypotheses. The third section describes the data and research methods, followed by a fourth section, in which the empirical

results are analysed. The paper ends with conclusions and suggestions for future research.

PRIOR RESEARCH AND HYPOTHESES

DETERMINANTS OF FUTURE- ORIENTED INFORMATION

FIRM CHARACTERISTICS

In a series of papers, Hussainey et al. (2003), Schleicher et al.(2007) and Hussainey and Walker (2009) provide evidence that future-oriented information in the annual report narratives contain value relevant information for investors to better anticipate future earnings. Their evidence is consistent with signalling theory. However, the authors did not explain in their papers what drives UK firms to voluntarily disclose this class of information in their reports.

The relationship between corporate disclosure and firm-specific and corporate governance characteristics has attracted major attention in prior research. A consistent finding across prior research is that four firm characteristics (firm size; gearing; profitability; and risk) and two corporate governance characteristics (number of non-executive directors on board and insider ownership) are the key drivers for corporate voluntary disclosure.

Ahmed and Courtis (1999) offer a meta-analysis of the results of 23 separate studies of the association between the levels of disclosure in the annual report and firm characteristics since 1961. They find that only four variables have a significant positive association with disclosure levels, namely: firm size, exchange listing status, audit firm size and leverage. In the present study, we focus only on firm size and leverage for a number of reasons. First, audit firm size is not *electronically* available for a large sample of firms at the time of

undertaking the analyses and also we argue that including non-executive directors in the models helps to capture the monitoring role that the audit committee provides. Second, the sample is based on all UK listed companies with no reported evidence in previous literature between disclosure levels and listing status (see for example, Botosan, 1997).

FIRM SIZE

The positive association between corporate disclosure and firm size is suggested by the signalling theory. This theory proposes that large firms tend to attract financial analysts and are more subject to greater demand for value-relevant information by financial analysts and their investors. In addition, these firms are more likely to have the funds for the cost of producing information for the user of annual reports.

LEVERAGE

Signalling theory is also used to explain the positive association between leverage and the levels of corporate disclosure. For example, Jensen and Meckling (1976) argue that highly leveraged firms have more monitoring costs. One possible response for highly leveraged firms to reduce these costs is to report more future-oriented information in their annual report narratives in order to convey value relevant information to satisfy the need of creditors.

PROFITABILITY

Ahmed and Courtis (1999) in their Meta analysis also find that there is considerable empirical evidence on the association between disclosure and profitability. However, the results of these studies are mixed. In particular, signalling theory suggests that profitable firms have an incentive to disclose more information to signal their favourable results to the stock market

participants. Therefore, one can anticipate that profitable firms are more likely to disclose future-oriented information in their annual report narratives. On the other hand, Schleicher et al. (2007) offer evidence that the publication of future-oriented information in the annual report narrative sections is considered a key source of information for unprofitable firms, but not for profitable firms. Consequently, the study expects a negative association between levels of future-oriented information in annual report narratives and the profitability of the firm.

RISK

Finally, prior research argues that increasing levels of corporate disclosure should reduce firm's risk (please see Espionsa and Trombetta, 2007). This is because rich disclosure environment should enhance stock liquidity and decrease its risk either by reducing transaction costs or increasing the demand on the stock and hence reducing the expected returns on the stock (Mouselli and Hussainey, 2009). As a result, a negative association between levels of future-oriented information and firm's risk is expected.

CORPORATE GOVERNANCE CHARACTERISTICS

BOARD COMPOSITION

The association between corporate voluntary disclosure and board composition is not clear, in spite of extensive empirical research on this relation, the results are mixed. For example, the findings in Beasley (1996), Chen and Jaggi (2000), Patelli and Prencipe (2007) and Li et al. (2008) support a positive association between board composition and corporate voluntary disclosure, while other studies (see Eng and Mak, 2003; Haniffa and Cooke, 2005) find a negative association. Ho and Wong (2001), Lakhali (2007) and Brammer and

Pavelin (2006) find no statistically significant association between the two variables. It must be noted that from the above-mentioned studies, only Lakhali (2007) implicitly examines the association between future-oriented information and board composition in France. The findings of Lakhali's study is in line with expectation, this is particularly true when taking into account the fact that '*French-listed firms are most controlled*'. As a result, the '*proposition of outside directors on the board is likely to be relatively weak*' (Lakhali, 2007: 68). Hence, it is important to revisit this evidence by including board composition in our models.

INSIDER OWNERSHIP

Li et al. (2008) examine the association between voluntary disclosure and insider ownership. They find a negative association between the two variables. Their finding suggests that UK companies with closely-held ownership have less information asymmetry between management and shareholders. This result is consistent with the findings of Cormier et al. (2005) and Brammer and Pavelin (2006). However, it is inconsistent with Patelli and Prencipe (2007) who find a positive association between the two variables. It is also worth noting that Eng and Mak (2003) did not find any statistically significant relationship between voluntary disclosure and insider ownership.

Based on the above discussion, we formulate the following hypotheses to examine the effect of firm characteristics and corporate governance on future-oriented information in annual report narratives:

H1: There is a positive relationship between the size of the firm and the level of future-oriented information in its annual report narratives.

H2: *There is a positive relationship between firm's leverage and the level of future-oriented information in its annual narratives.*

H3: *There is a relationship between firm's profitability and the level of future-oriented information in its annual narratives.*

H4: *There is a negative relationship between firm's risk and the level of future-oriented information in its annual narratives.*

H5: *There is a relationship between the number of outside directors on board and the level of future-oriented information in its annual narratives.*

H6: *There is a negative relationship between closely-held ownership and the level of future-oriented information in its annual narratives.*

THE LINK BETWEEN DIVIDEND POLICY AND FUTURE-ORIENTED INFORMATION

The link between dividend policy and future-oriented information has received much attention in recent years. For example, in a recent paper, Hussainey and Walker (2009) examine the extent to which future-oriented information and dividend propensity are substitute or complement forms for communicating the value relevant information to investors. They offer evidence that the two variables are substitutes. Their results are consistent with signalling theory, but not consistent with pecking order theory (Deshmukh, 2005). Signalling theory suggests that firms with higher levels of asymmetric information (i.e. lower levels of future-oriented information) are more likely to pay higher levels of dividends to signal their future prospects to current and potential investors. However, pecking order theory suggests that firms with higher levels asymmetric information (i.e. lower levels of future-oriented information) are more likely to be underinvested. To control the underinvestment situation, these firms are more likely to lower their dividends.

Prior US studies on the association between asymmetric information and dividends, such as Deshmukh (2003; 2005) and Li and Zhao (2008), still offer mixed results. Consequently, the association between dividend and levels of future-oriented information (as a measure of information asymmetry) remains a challenge and source of much debate. This association is, therefore, one of the main issues to be empirically examined within the current paper. Hence, it can be hypothesized that:

***H7:** There is a relationship between dividend policy and the level of future-oriented information in its annual narratives.*

It is worth noting that we controlled for other determinants of dividend policy, namely, we control for, firm size, borrowing ratio, profitability, risk, liquidity, growth opportunities, insider ownership, and nonexecutive directors. (for more discussion about these variables please see Al-Najjar and Hussainey, 2009)

SAMPLING DESIGN AND RESEARCH METHOD

SAMPLING DESIGN

Our paper examines the determinants of future-oriented information and the link between this information and dividend policy for UK listed companies at the London Stock Exchange for financial year-ends between January 1996 and December 2002. The sample period goes from 1996 to 2002 because we limit our analysis to all non-financial firms that have at least one annual report in an electronic format *Dialog* database. *Dialog* covers large cross-sectional annual reports only for this period of time. The total number of annual reports on *Dialog* for non-financial firms for this period of time is 8,098 firm-years. We match this sample with an updated version of the ICCSR UK Environmental &

Financial Dataset, which contained information for UK firms from 1996 till 2002.² It is worth noting that the period of time investigated is the same as that used by Hussainey and Walker (2009). We use ICCSR database because it contains information about board size and board composition for a large number of firms. Financial firms are excluded from the analyses. The sample also excludes any firms with no financial and accounting records on *Datastream* or *Worldscope*. This gives us a final sample of 357 non-financial firms (1860 firm-years) for the period from 1996 to 2002 inclusive.

RESEARCH METHODS

DETERMINANTS OF FUTURE-ORIENTED INFORMATION

This section reveals the empirical part of this paper and shows the applied econometrics models. This study applies three types of models, starting with the fixed effects model, then the random effects tobit model, and finally the random effects logit model. The reason behind using the tobit model is the fact that disclosure index has either a positive or zero values which justifies using it. The logit model is applied to investigate the factors that affect the firm decision to disclose or conceal future-oriented information in the annual report narrative sections. The following model represents our fixed effects model:

$$D_{it} = \alpha_i + \beta' X_{it} + \varepsilon_{it}$$

Where

D_{it} is the future-oriented disclosure measure.

α is the Intercept coefficient of firm i .

² We wish to thank the International Centre for Corporate Social Responsibility (ICCSR), Nottingham Business School Nottingham University (UK) for allowing us to use *Datastream* items 242 and 243 for our research projects.

β' is the Row vector of slope coefficients of regressors.

X_{it} is the Column vector of financial variables for firm i at time t , this vector is made up of the following: crossholding share, firm size, profitability of the firm (return on assets), non-executive directors, and firms beta.

ε_{it} is the residual error for firm i at year t .

The random tobit model can be expressed as

$$\left[\begin{array}{l} D_{it} = \alpha + \beta' X_{it} + \varepsilon_{it} \\ = 0 \end{array} \quad \begin{array}{l} \text{if the right - hand side} > 0 \\ \text{otherwise} \end{array} \right]$$

In the tobit models, we use the same variables as those used in the fixed effects model. Finally, we use the logit model, which has a dependent variable of 1 if the level of future-oriented information is greater than zero and 0 otherwise. Again, dependent variables are the same as those used for tobit and fixed effect models.

THE LINK BETWEEN FUTURE-ORIENTED INFORMATION AND DIVIDENDS

Similarly, we identify the tobit, fixed effect and logit models to examine the association between dividends and future-oriented information in annual report narratives. In the analyses, we use dividend as the dependent variable and levels of future-oriented information in annual report narratives as the main independent variable. A set of control firm characteristics and corporate governance variables that are more likely to affect corporate dividend policy are also used. In accordance with Al-Najjar and Hussainey (2009), firm risk, liquidity, growth opportunity, gearing, profitability, firm size, insider ownership and outside directorship on the board are controlled for.

COUNT OF FUTURE-ORIENTED INFORMATION

The same measure of disclosure quality developed in Hussainey et al. (2003) is adopted. They generate their disclosure scores for a large sample of UK annual reports automatically by using QSR N6 software. Their measure of disclosure quality is the number of future oriented statements in corporate annual report narrative sections that contain earnings-related topics. The same measure of disclosure is used within this research and also focuses on future earnings indicators. Hussainey et al. (2003), Schleicher et al. (2007), and Hussainey and Walker (2009) find that these indicators increase the stock market's ability to foresee future earnings change.

Similar to Hussainey et al. (2003), the disclosure score for the investigated sample is estimated in three steps. In the first step, the narrative sections of annual reports for future oriented information are researched. The list of future oriented information keywords created by Hussainey et al. (2003, p. 277) is used. This list includes thirty-five keywords as follows: *accelerate, anticipate, await, coming (financial) year(s), coming months, confidence (or confident), convince, (current) financial year, envisage, estimate, eventual, expect, forecast, forthcoming, hope, intend (or intention), likely (or unlikely), look forward (or look ahead), next, novel, optimistic, outlook, planned (or planning), predict, prospect, remain, renew, scope for (or scope to), shall, shortly, should, soon, will, well placed (or well positioned), year(s) ahead.* Similar to Hussainey et al. (2003) the study takes into account the future year numbers in the list of future oriented keywords. In the second step, the relevant information to the stock market in assessing the firm's future earnings is identified. For the purpose of the current paper, the same list created by

Hussainey et al. (2003, p. 280) that is related to earnings indicators is used. The list contains the following twelve keywords *benefit, breakeven, budget, contribution, earnings, EPS, loss, margin, profit, profitability, return and trading*. Finally, QSR N6 is applied to count the number of sentences that include both at least one future oriented keyword and at least one earnings indicator.

OTHER VARIABLES DEFINITIONS

Closely holding shares is the percentage of a firm's common stock held by insiders which acts as an index for insider power (*Worldscope* item no. 08021). Firm size is the natural logarithm of total assets. This measure includes tangible fixed assets, intangible assets investment, other assets, total stocks and work in process, total debtors and equivalent and cash and cash equivalents (*Datastream* item 392). We collect return on assets from *Datastream* as a measure of firm profitability. *Datastream* defines return on assets as net income plus interest on debt after tax divided by last year total assets. Borrowing ratio is the total loans divided by equity capital and reserves minus total intangibles (*Datastream* item no. 733). Non-executive directors (ND) represent the percentage of board directors employed in non executive roles (*Datastream* item 243). The Business risk measure is beta which is collected from *Datastream*. Our measure for liquidity is current assets to current ratio, *Worldscope* item no. 08106). The measure of growth opportunity is *Datastream* item PTBV defined as the price divided by the book value or net tangible assets per share for the appropriate financial year end, adjusted for capital changes.

EMPIRICAL RESULTS

Table 1 presents the results of the panel-data with random and fixed effect regression analyses (with and without year dummies). It also presents the results of a logistic regression analysis. Given that the results on the determinants of voluntary disclosure in prior research are mixed, Table 1 might explain the reasons for the mixed results and offer a better picture of the association between corporate disclosure, firm characteristics and corporate governance structure.

Hypothesis H1 predicts that there is a positive relationship between firm size and the levels of future-oriented information in annual report narratives. The results indicate that the coefficient of size is positive and statistically significant in the five regression models presented in Table 1. These results suggest that large UK firms are more likely to increase the level of future-oriented information in the annual report narratives than small firms. Therefore, we accept H1.

Hypothesis H2 expects that there is a positive association between leverage and the levels of future-oriented information in annual report narratives. The results indicate that the coefficient on BORR is negative and statistically insignificant in the five regression models presented in Table 1. These results suggest that corporate level of leverage is not associated with the level of future-oriented information in the annual report narratives. Hence, H2 is rejected.

Hypothesis H3 anticipates that profitability will have an effect on the levels of future-oriented information in annual report narratives. The results indicate that the coefficient on ROA is negative and statistically significant in two of the five regression models presented in Table 1. These results suggest that it is not valid to conclude that unprofitable firms are more likely to produce higher levels of future-oriented information in the annual report narratives than profitable firms. Therefore, there is limited support for H3..

Hypothesis H4 forecasts that reporting future-oriented information in annual report narratives sections is associated with corporate risk. However, the coefficients on BETA are positive and negative (none is statistically significant) in the five regression models presented in Table 1. These results indicate that there is no association between risk and levels of future-oriented information in the annual report narratives. Hence, H4 is rejected.

Hypothesis H5 expects an association between board composition and levels of future-oriented information in annual report narratives. The results indicate that the coefficients on NEXDR are positive and negative and statistically significant in two of the five regression models presented in Table 1. These results suggest that it is not credible to conclude that firms with large number or directors on board use more or less future-oriented information in the annual report narratives. Hence, there is limited support for H5.

Hypothesis H6 predicts that insider ownership has an effect on levels of future-oriented information in annual report narratives. The results indicate that

the coefficients of CHS are positive and negative and statistically significant when we use the fixed effect tobit analyses (with or without years dummy). These results suggest that it is not feasible to conclude that firms with large portion of insider ownership use more or less future-oriented information in the annual report narratives. Therefore, there is limited support for H6.

Finally, hypothesis H7 expects that there is an association between levels of future-oriented information and corporate dividend policy. Table 2 reports the results of the panel-data with fixed, random effect regression analyses as well as the logistic regression analyses. Table 2 shows that there is a positive association between levels of future-oriented information in the annual report narrative sections and corporate dividend policy. This finding is consistent with pecking order theory. In particular, the theory suggests that firms with lower levels asymmetric information (i.e. higher levels of future-oriented information) are more likely to higher their dividends. This finding is inconsistent with signalling theory. This finding is consistent with that reported by Deshmukh (2005) on a sample of US companies. The result suggests that firms that pay dividends are more likely to increase the level of future-oriented information in their annual report narrative section. In this case, firms can use either dividends or disclosure to signal value-relevant information for the stock market participants.

It is well known that dividend policy is considered as one of effective mechanisms that can be used by managers to mitigate agency conflicts of interest within the firm (Bathala and Rao, 1995). Increasing levels of future-oriented information in the annual report narratives is considered as a mean to

reduce information asymmetry between managers and current and potential investors. Reducing asymmetric information should also help in reducing conflict of interests between managers and shareholders and hence reducing agency costs. To summarise, dividends and future-oriented disclosure are complement mechanisms used by UK listed companies to reduce agency costs. Based on these results, hypothesis H7 is accepted.

Our control variables give the same results as those reported in the previous dividend policy literature. In particular, Table 2 shows mixed results for firm size and profitability (with positive and negative significant results). Risk is negatively related to dividend policy, suggesting that risky firms are less likely to pay dividends. Both corporate governance factors, insider ownership and nonexecutive directors, produce the expected negative sign, therefore, increasing the percentage of nonexecutive directors in the board; and the more the insider owners, the lower the need to pay dividends. These results are consistent with Al-Najjar and Hussainey (2009).

CONCLUSION

In this study, panel Tobit and Logit regression models are used to investigate the determinants of corporate future-oriented information in the annual report narrative sections. As hypothesized, the results indicate that firm size is the main determinant of future-oriented information for UK firms listed at the London Stock Exchange.

The study also examines the association between future-oriented information and dividend policy. As expected, a positive association is reported between the two variables. The findings indicate that firms with higher levels

of future-oriented information exhibit lower levels of information asymmetry and hence higher levels of dividends. This result is in line with picking order theory, but inconsistent with signalling theory.

It is important to note that the findings of our research should be interpreted in light of limiting our study to the year 2002. However, new reporting rules for narrative disclosure (i.e. operating and finance review) have been issued. Therefore, future studies are needed to examine the same research issues for years beyond 2002. In addition, further research is needed to consider the effect of other corporate governance variables (i.e. audit committee characteristics) on levels of future-oriented information. Finally, the current study uses data from UK non-financial firms: further studies are needed to examine the extent to which the current results are applicable for financial companies or other countries.

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Table (1): Determinants of Future-Oriented Narrative Reporting

<i>Independent Variables</i>	Fixed-effects models		<i>Random-effects tobit models</i>		Random-effects logistic model
	Without years dummy	With years dummy	Without years dummy	With years dummy	
Intercept	-6.378942**	-.0221179	-8.375315***	-7.765003***	.4352021
Size	.8740846***	.3977313*	1.110618***	1.044464***	.4151392***
BORR	-.0012396	-.0004371	-.0008001	-.0003232	-.0007085
ROA	-.0195327*	-.0069005	-.0170527*	-.0077538	-.0040131
Beta	.1545213	.18917	-.0381649	-.0432862	-.0161433
NEXDR	.1638046	-2.043972*	-.7486529	-1.721843*	-.2976772
CHS	.1270611**	.1403545**	.0632107	.0688869	-.1413472
Observations	1860	1860	1860	1860	1860
F-Value	5.33***	5.50***			
Wald chi2(8)			132.48	157.97	14.16
Prob > chi2			0.0000	0.0000	0.0279

Size = Log total asset; BORR= Borrowing ratio; ROA = Return on Assets; BETA= Firm Risk for the firm; NEXDR = The number of outside directorships on boards; CHS = Closely held shares. The significance levels are: * = 10 percent, ** = 5 percent, *** = 1 percent.

Table (2): Future-Oriented Narrative Reporting and Dividend Policy

<i>Independent Variables</i>	Fixed-effects models		<i>Random-effects tobit models</i>		Random-effects logistic model
	Without years dummy	With years dummy	Without years dummy	With years dummy	
Intercept	3.934007***	3.980554***	2.412632***	2.23459**	1.831927
Future Disclosure	.0131378*	.0129369*	.0148202*	.0152126*	.1936827***
SIZE	-.1850791***	-.189934**	-.0788344	-.0673784	.5902575**
BORR	.000354	.0001121	.0002692	.0000381	.0223444
ROA	-.0104139***	-.0106118***	-.0087241**	-.0094453***	.1358564***
Beta	.0941989	.1140728	.1233792	.1393037	-1.352552***
LIQ	-.037615	-.0352308	-.0377479	-.0361549	-.3852685
MTBV	.0000231	.0000211	.0000239	.0000165	-.0006447
CHS	-.0684596***	-.0680216***	-.0582569***	-.058235***	-.0222109
NEXDR	-.2827165	-.2889346	-.1753319	-.1036647	-4.547272**
Observations	1704	1704	1704	1704	1704
F-Value	3.53***	2.63***			
Wald chi2(8)			23.74	31.55	58.92
Prob > chi2			0.0047	0.0074	0.0000

Future Disclosure = Number of future-oriented sentences in the annual report narratives; Size = Log total asset; BORR= Borrowing ratio; ROA = Return on Assets; BETA= Firm Risk for the firm; LIQ = liquidity ratio; MTBV = market to book value; CHS = Closely held shares. NEXDR = The number of outside directorships on boards; The significance levels are: * = 10 percent, ** = 5 percent, *** = 1 percent.