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We tracked how investors read company reports and here's how they're misled

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Investors would have spent a fair amount of time over the last few weeks poring over financial documents, as listed companies report their earnings and plans for the year to come. But our research shows they could have been misled just by the order of information in these reports.

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We found that investors place more emphasis on the last piece of information in the management report included in company documents. Non-professional investors also ranked the performance of the company higher on more occasions, if the last piece of information is positive.

We invited 66 non-professional investors in our laboratory to read a management report of a fictitious mining company containing a short series of complex and mixed information. The positive information contained in the report told of increases in financial profitability and a strong operating cash flow. Negative information included a declining share price and increases in costs.

We randomly assigned the participants to two groups. The first group read the textual information included in the report in a sequence of positive information first and negative last. The second group read exactly the same information, but for them it was presented in the opposite way, negative before positive. We used an eye-tracking device to ensure that all information included in the management report was read and considered in light of judgement formation.

The investors we studied actually used the fictitious information in their investment decisions. Over 60% of participants were less inclined to invest in the fictitious company when negative information was presented last.

Easily mislead

Research into the behaviour of investors shows that the presentation order of financial information influences their judgements on company performance.

Because of the limited attention span and working memory capacity of the human mind, investors give more weight to information received later in a sequence.

So although financial information is often regarded as objective, neutral and value-free, the deliberate presentation ordering of information is able to influence non-professional investors. Companies could use this to try and hide negative information in the middle sections of a narrative and disclose positive information at the end of a sequence for the greatest effect.

Presentation ordering is not the only trick companies may use to influence the perceptions of annual report readers.

Graphs can attract investor's attention and can be more easily retained in their memory than other narratives. Because of this, companies use significantly more graphs highlighting favourable rather than unfavourable performance.

One concern that arises from our findings is that readers of financial information may be mislead into believing there is more objectivity in practice than actually is the case. With regulatory efforts largely related to quantitative information, companies have much more flexibility in terms of how they present narrative information accompanying the financial statements in their reports.

Perhaps further guidance on the presentation of the management commentary is required by the global regulators to restrict the possibility that companies may influence the impressions conveyed to users of accounting information.

Maybe next reporting season investors should take another look at what information companies include in their reports.

ABOUT THE AUTHOR

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