Credibility of Financial Reporting Communication Between Investors and Management: An Exploratory Study

Mostafa H. Alsohagy, *University of East London*

***Abstract*— the purpose of the paper is to examine the role of credibility in achieving successful communication processes in financial reporting and to suggest a theoretical framework based on source credibility theory that can be used to design research exploring credibility as a dimension of communication in financial reporting. The research approach adopted here is a comprehensive, interdisciplinary review drawing on sources from academic and professional communication, financial reporting, and credibility studies. The framework proposed drives researchers towards considering the financial reporting process holistically, examining senders, receivers, channels and noise, and not simply factors but levels of persuasion and changes in attitude. If financial reporting is the product, and users are the audience, source credibility theory potentially offers another means of understanding why audiences might be more persuaded by one means of financial reporting than another. This paper is the first attempt to call the attention of financial reporting scholars to the area of communication through studying the credibility of communication and its effects on the successfulness of communication process. Also, the paper contributes to the debate relating to the understanding of the factors and dimensions of comprehensive credibility that includes all parties involved in the financial reporting communication process.**

***Index Terms*— Financial Reporting, Communication, Source Credibility**

I. Introduction

Financial reporting can be seen as a communication process through which managers communicate with investors in order to justify the financial position of companies, and through which investors rely on the communications in taking decisions [1]. Ideally, information provided should be comprehensive and include all parties involved in the process [2], yet few prior research studies deal with financial reporting as a whole communication process, tending rather to investigate aspects such as readability or understandability of information [3], [4] or one factor such as content or language of financial statements [2], to the neglect of more holistic features, including credibility.

Despite the intuitive importance of credibility in financial reporting communications, there appears to be only a preliminary understanding of the factors and dimensions of comprehensive credibility that includes all parties involved in the financial reporting communication process. This gap is addressed here by exploring the role of credibility in financial reporting communication processes and how credibility might affect the success of such communications. Drawing on research in psychology and other disciplines, source credibility theory is proposed as a framework with which to explore these questions in context. The potential importance of the theory to financial reporting processes lies in Reference [5] observation that source credibility theory can be applied wherever there is a product and an audience. Thus, it may be possible to use the framework in future to confront such questions in financial reporting as why users chose to believe the reports of companies that failed within a year of the publication of a report and why some reporting mechanisms may be more effective than others in establishing credibility.

II. FINANCIAL REPORTING COMMUNICATION AND CREDIBILITY

The Concept of Credibility

Credibility has been examined across a number of fields ranging from communication, information science, psychology, marketing, and the management sciences to interdisciplinary efforts in human-computer interaction. It also has been defined in terms of characteristics of persuasive sources, characteristics of the message structure and content, and perceptions of media. Each field has examined the construct and its practical significance using fundamentally different approaches, goals, and presuppositions, all of which results in conflicting views of credibility and its effects [6].

According to theorists, credibility is regarded as a multidimensional concept comprising the perceiver's assessment of the communicator's relevant knowledge, honesty and good intentions towards the perceiver [7]. Reference [8] identifies four types of source credibility:

- *Presumed credibility* arising from the assumptions of the perceiver.
- *Reputed credibility* based on source labels.
- *Surface credibility* assigned on a user's simple inspection of superficial characteristics.
- *Experienced credibility* based on a user's first-hand experience with a source over time.

Based on the above, some studies focus on the characteristics that make sources or information worthy of being believed, while others examine the characteristics that make sources or

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information likely to be believed [9]. Although the concept of credibility is complex and is variously defined as trust, persuasion, accuracy, fairness, objectivity, and dozens of other concepts, in the simplest terms it may be defined as 'believability' [8]. Reference [10], states that credibility is perceiver's assessments of believability or of whether a given speaker is likely to provide messages that will be reliable guides to belief and behaviour.

Trust has been a core construct in many conceptualizations of credibility [11]. However, Reference [8] point out that, 'although they [credibility and trust] are related, trust and credibility are not synonymous. Trust indicates a positive belief about the perceived reliability of, dependability of, and confidence in a person, object, or process', while credibility is synonymous with believability. Trust frequently refers to beliefs, dispositions, and behaviours associated with the acceptance of risk and vulnerability whereas credibility refers to a perceived quality of a source, which may or may not result in associated trusting behaviours [6], [8].

Similarly, credibility should not be confused with persuasion. Aristotle's discussion of ethos is among the first attempts to conceptualise what is referred to here as source credibility [6]. Research has tested situations in which source credibility exerts no effect on persuasion or decreases the effect [5]. Although source credibility is a critical determinant of message acceptance [12], the two constructs are not equivalent [6]. Furthermore, in persuading users of the quality of information, credibility represents one layer out of many layers that indicate whether information can be regarded as being of high quality [6].

Credibility of financial reporting

In one of the few studies applying the concept of credibility to financial reporting, Reference [13] notes that management disclosures are a potentially valuable source of information for investors, but must be perceived as credible to be used. Investor reactions to a management disclosure are a function of both the new information "surprise" contained in the disclosure and the credibility "believability" of the disclosure. He refers to the importance of disclosure's credibility of new information in explaining investors' reactions. In particular, when investors initially receive a disclosure from management, they are likely unaware of the disclosure's actual reliability or quality and will base their reactions on its perceived credibility [13].

According to Reference [14], disclosure credibility is not synonymous with management credibility. Management credibility can be defined as a more enduring trait of a firm's managers, referring to investors' perceptions of managers' competence and trustworthiness [11] whilst disclosure credibility is appraised separately for each disclosure and may vary within a firm across different disclosures. Reference [15], on the other hand, refers to the way in which investors use a range of common sources of accounting information across decision contexts, finding that sources with low credibility either have their messages discounted in various ways or cause decision makers to expend more effort in coming to a decision. His work reveals that perceptions of source credibility may at times be influenced by questionable attributions of source accountability and independence. Decision context affects the value that investors place on the source of the information compared to the information itself.

One of these contexts could be whether or not information is disaggregated. Reference [16] suggest that disaggregation influences perceived forecast credibility via three mechanisms. First, a positive signal of the precision (or certainty) of management's beliefs about the forecast is provided. Second, a disaggregated forecast provides additional clarity and third, the provision of a disaggregated earnings forecast enhances perception of financial reporting quality, making forecasts appear more credible and counteracting the effect of high incentives.

However none of these studies, that are representative of the literature, examines the nature or components of credibility rather than its outward effects. For that, a more structured and comprehensive framework is needed and can be found in source credibility theory as developed in psychology and developed in marketing and other management related disciplines.

III. THEORETICAL FRAMEWORK

Source Credibility theory

The foundations to source credibility theory were laid by Hovland, a psychologist, who identified perceived trustworthiness and perceived expertise as the main dimensions of a source's credibility [11]. The higher the trustworthiness and expertise a source is perceived to have, the higher will be the importance given to information coming from that source. Early work in the field applied source credibility in the context of public opinion and interpersonal communication. Later studies have shown that source credibility theory applies also to commercial settings where the receiver of information is evaluating possible transactions [17], [5].

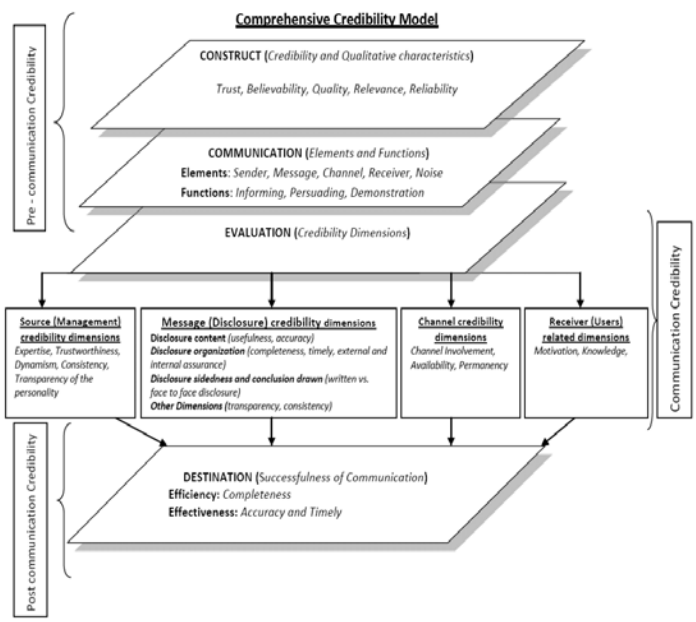
Here, source credibility theory will be used not only in reference to the communicator (management) but also to refer to the messages (disclosure both financial and non financial) and the channels (annual reports, web pages, conferences call, etc). In other words, source credibility in financial reporting communication process includes the credibility of communicator, messages and channels, within the context of the regulations and rules which organize the financial reporting communication process. This assumption is consistent with the opinion of Reference [18] who extended the Yale analysis for source credibility and suggested that the communication process as: 'who (source) says what (message) to whom (receiver) how (channel) and with what effect (destination)' [19].

Following the social psychology perspective that treats credibility as a perceptual variable, credibility here is not an objective property of a source or a piece of information but rather a subjective perception on the part of the information receiver. This perspective emphasizes audience perceptions of credibility rather than the objective credibility of a source or piece of information [20].

Based on this view, the theoretical framework suggested here (adopted from Yale approach for source credibility theory and credibility assessment framework presented by Reference [21]) has four main stages:

1. A ***Construct stage*** in which credibility concepts should be identified.
2. A ***Communication stage*** in which functions and elements of financial reporting communication should be classified.
3. An ***Evaluation stage*** in which credibility dimensions influencing financial reporting communication process can be distinguished into (1) Source credibility related factors, (2) Message credibility related factors, (3) Channel credibility related factors, and (4) Receiver related factors.
4. A ***Destination stage*** includes the effects of credibility or the role of credibility in achieving successful financial reporting communication process.

These four stages can be re-classified into three steps. The *pre-communication credibility step* involves the construct and communication stages. The *communication credibility step* represents the evaluation stage (credibility dimensions). Finally, the *post-communication step* includes the destination stage (credibility effects). The following Figure demonstrates the whole framework:



Construct Stage (*Credibility and Qualitative Characteristics*)

The construct stage concerns the way in which credibility is conceptualised and defined, and should include differentiating or distinguishing between credibility and other related concepts. In contemporary financial reporting these related concepts could be seen as the qualitative characteristics of financial reports as given in the conceptual frameworks of the main standard setting bodies. What, for example, is the link between credibility and usefulness? Reference [22] for example, denotes the qualitative characteristics as understandability, relevance, reliability and comparability. Thus for example, credibility assessments are often taken to be a subset of relevance judgments, defined as users' perceptions of the potential usefulness of information with relevance judgments defined as users' decisions to accept or reject specific information items [6]. Information quality, credibility, and cognitive authority are those criteria that have appeared consistently across relevance studies [6]. Hence credibility can be seen as different from relevance in that relevance is the user perception of the usefulness of information while credibility is one of the criteria that needed to decide whether or not information is relevant. Similarly with reliability, Reference [23] observes that "Reliability refers to the speaker's ability to know the truth and speak it, while credibility refers to the ability of the speaker to inspire the trust in his listener, or the degree to which his observations are taken to be correct… Reliability lies solely in the speaker, while credibility, one could say is a 'joint venture' of speaker and listener". Thus, conceptually, credibility is not a qualitative characteristic of information itself but is more appropriately seen as characteristic of the financial reporting process, by which that information is created, or the individual or entity that provides the information [24].

Communication Stage (*Elements and Functions*)

In this second stage, the concern is to indicate the elements and functions of communication, and here the notion of a communication model is useful. Communication elements in each communication model are selected to fit a particular situation being examined [25]. For example, Aristotle's model of communication includes three main elements: Speaker, Subject, and Receiver, whereas in Reference [26] model, there are five elements: Source, Transmitter, Channel, Receiver, and Destination. Differences in models relate to differences in purpose and background for which the models were developed [25].

In developing a model of a communication for financial reporting, one must include elements that analyse financial reporting as a communication process. Although the elements vary from one communication model to another, most of these models shared in five basic elements: *Sender*, *Message*, *Channel*, *Receiver* and *Noise*.

Thus in financial reporting, the *sender* is the company's management. The *receiver* is the users who include Institutional equity investors, Sell-side equity analysts, Credit investors, Private shareholders. The *message* represented in many forms of disclosures such as company announcements, annual report and accounts, annual report and accounts of regulated subsidiary, social and environmental report, forecasts, and operating information. The *channels* in financial reporting communication process may be public (such as newswires, newspapers, hard copies of reports, website), semiprivate (such as Results meetings, Conference calls CD prepared by group treasurer, Company newsletters, Intranet) or private (such as One-to-one meetings, Telephone and email) [27].

Noise in financial reporting means sending incorrect messages or information. A correct message presents the true financial position and performance of the company while an incorrect message (message with noise) involves misleading users. Therefore, noise in financial reporting communication (related to sender or management) refers to manipulation and of course, manipulation - such as the deliberate misapplication of accounting principles or insufficient disclosure [28] - has negative effects on credibility of management [29].

Developing this further, the main functions in financial reporting processes can be identified as Sender (management) related functions, receiver (users) related functions, and Message (disclosure) related functions. The management related functions represented in selecting information to be communicated, encoding the information as a messages, transmitting the encoded messages to the users [25]. User related functions, in contrast, are the interpretation of messages received and the use of these messages to rationalize their decisions [25].

Reference [30] distinguishes between three main message functions: inform functions where the sender (management) is responsible for disclosing information both financial and non-financial to the receivers (users). The receivers require timely and accurate information to make effective decisions; persuading functions, usually involving the 'selling' of an idea, product or services to a person or group and demonstration functions, which include justifying the current results and demonstrating accountability. Once elucidated, these functions can form the basis of an evaluation of source credibility in financial reporting processes.

Evaluation Stage (Credibility Dimensions)

Although message and receiver characteristics have received significant amounts of attention, much less attention has been given to the source and channel used to transmit the message [31]. If management is accepted as being the source and the various mechanisms of reporting as the channels, then the following dimensions of the framework can be developed in the context of financial reporting processes.

Source (Management) credibility dimensions

In psychological studies, the constituent part of message communication, communicator credibility, is defined by Reference [11] as 'source credibility', which is a term commonly used to imply a communicator's positive characteristics that affect the receiver's acceptance of a message – its perceived expertness and perceived trustworthiness. *Expertise* is defined as the extent to which a communicator is perceived to be the source of valid. However, the initial opinion of the message recipient may confound this effect and in certain circumstances, a non-expert source may be perceived as more credible than an expert source [32]. *Trustworthiness,* on the other hand, is defined as the degree of confidence in the communicator's intent to communicate the assertions he\she considers most valid or, more simply, a listener's trust in the speaker [11].

After Reference [11], others began to investigate the multidimensionality of credibility. Reference [33] provided similar dimensions for credibility (authoritativeness and character) whereas Reference [34] uses three dimensions, trustworthiness, qualification and dynamism. Reference [35] expands on their work, saying that *trustworthiness* refers to the sense of interpersonal safety that a person may feel toward another whilst *qualification* refers to the skills and experience. *Dynamism* refers to the activeness or performance of the person. The more performance or activeness of the person has, the more credible he or she will be.

In a financial reporting context, Reference [36] distinguishes between two main management credibility factors (competence and trustworthiness) and there are many studies that combine the effects of management credibility and the accuracy of earning forecasts [37], [38], [16]. For example, the greater the accuracy in management forecasts in the past, the greater the trust in management [16], whilst managers who accurately forecast earnings have higher perceived competence and trustworthiness than managers who significantly overstate or understate earnings [37]. However, Reference [36] indicates that management credibility is only one factor that affects disclosure credibility.

Message (Disclosure) credibility dimensions

Message credibility examines how message characteristics impact perceptions of believability, which Reference [39] believe might be more important than source factors in evaluating credibility. Message credibility can be affected by the following dimensions: the message content (Disclosure content), the message organisation (Disclosure organization), the messages sided-ness and conclusions drawn (written vs. face to face disclosure), and other dimensions (transparency and consistency) [40], [41], [42].

Message content (Disclosure content)

Psychological research shows that credibility judgments are influenced by message content factors such as information quality, language intensity, and message discrepancy. For example, Reference [43] found that perceptions of message quality (how well-written and interesting readers perceived the message to be) affected credibility assessments. For financial reporting, Reference [13] suggests that in making credibility judgements, disclosures are judged on their potential useful as sources of information for investor and analyst decision-making. Furthermore, various empirical studies indicate that investors perceive accurate disclosures as more credible than inaccurate disclosures [37], [16], [44]. Management disclosures will lose credibility if the provided information turns out to be inaccurate whereas firms with a reputation for accurate disclosures are more likely to influence investors in their subsequent disclosures [44], [45].

Message organisation (Disclosure organization)

Reference [19] notes that the quantity and organisation of items of information contained in the message affect perceptions of credibility: unorganized messages are perceived as less credible than well-organized messages whilst too much information may confuse the receiver [39]. In financial reporting, prior studies suggest that the disclosure organization factors such as completeness, timeliness, and external and internal assurance will affect investors' perceptions of disclosure's credibility [36], [37],[38], [44], [45]. When investors receive incomplete information, their ability to derive proper firm valuation is hampered since incomplete information increases investor uncertainty [46]. No studies directly examine the management credibility consequences of more complete disclosure, although Reference [47] concludes that disclosures that are more complete are associated with positive stock price effects and Reference [44] indicate that complete disclosure leads to higher management credibility, which in turn leads to a lower cost of capital. Managers who provide timely warnings about unexpected negative earnings are considered as having higher credibility than managers who do not provide this information [38] whilst managers' trades-off credibility gains from making a precise and timely disclosure against the risk that the information will turn out to be imprecise [44]. Finally, there are a number of studies that indicate that internal assurance (such as that from audit committees and internal auditors) and external assurance (such as that from external auditors and financial analysts) also affects credibility of disclosure [14], [48].

Message sidedness and Conclusions drawn

Two-sided messages, which present both good and bad points are more effective than a one-sided messages: this message credibility factor is particularly effective when the receiver's initial opinion is opposite to that presented in the message [41]. Furthermore, a message may include, on the one hand, the conclusion that can be drawn from its argument, or, on the other, may leave the conclusion for the audience to decide upon from the argument presented. Early experiments suggest that conclusions should be stated for the audience, but recent research indicates that the best advertisements ask questions and allow the receiver to form his or her own conclusion [32]. It would be interesting to test whether the same observation holds for financial reporting products. For instance, Reference [14] indicates that face to face disclosure (such as conference calls) is more credible than written disclosure (such as press releases).

Finally, two dimensions - transparency and consistency – have been put forward by researchers for consideration in the evaluation of credibility. Reference [40] conclude that meeting a transparency condition (defined by them as "What you see is what you get") is key requirement for successful communication and helps to achieve a higher level of credibility with audiences. For Reference [42], consistency is considered as the heart and soul of credibility and is based on the five correlated dimensions of objectives, actions and words, style, priorities and roles. Thus, a credible financial report would be one in which actions, messages and words are aligned to the objectives of communication, delivered to target prioritised audiences in recognisable manner and style ostensibly from a designated person responsible for the financial communication process (such as a CEO). Achievement of consistency may depend on the channel used [14].

Channel credibility dimensions

Channel credibility refers to the audiences' perceptions of a channel's believability, as distinct from the believability of the sources, or the content of the message itself [49]. The channel credibility can be affected by three components: channel availability, channel permanency, and channel involvement [50]. Involvement implies the effort required by all senses in order to receive information from a communication channel. For example, face to face communication offers the greatest possibility for involvement where print channel offer the least possibility for involvement although print may be more available and permanent. Whether one is more credible than the other requires an analysis of context to assess.

Receiver (Users) credibility dimensions

The receiver of communication will be influenced by a number of factors that will mediate the extent to which he or she will accept or reject the message [32], [41].

Some recipients of a persuasive message will be well motivated and will carefully process and evaluate the communication. Others however, may just ignore the message or expend little effort on processing and evaluating it [32]. Partly, this would depend on whether users are knowledgeable about the topic of a message and so better able to evaluate the strengths and weaknesses of the claims and to elaborate on them more easily.

In summary comprehensive credibility, which is required for financial reporting communication processes can be distinguished into the following credibility dimensions relating to:

- *messages* through usefulness, timely, completeness, accuracy, internal/external assurance, transparency, and consistency;
- *sources* through trustworthiness, expertness, dynamism, and consistency of the role, and transparency of the personality;
- *channels* through involvement, availability, and permanency;
- *receivers* as knowledge and motivation.

Destination Stage (Successfulness of Communication)

The final destination stage applies the above evaluation to the outcome of the communication. Credible communication often results in investor decisions to buy or sell shares of the firm's stock. When investors receive any information in the financial reports, their reactions will be based in part on their judgments regarding the credibility, or believability, of this information [51]. By improving communication credibility, communicators might avoid the audiences' misunderstanding, uncertainty and adverse reaction to proposed objectives. In addition, if investors receive a number of credible information from a firm, this supports their confidence in the firm's managers, and leads them to be more likely to keep the firm's stock in their portfolio. Credible financial reporting communication influences positively investors' decision-making processes [36].

There is agreement that effectiveness and efficiency are the main indicators for examining the success of any communication process where efficient communication means providing only the information that is needed (sufficiency) and effective communication means providing the information in the right format (accuracy), and at the right time (timeliness) [52]. These main indicators for the success of any communication process are parts or included within the dimensions of the comprehensive credibility.

V. IMPLICATIONS FOR FUTURE WORK

Disciplines from outside financial reporting deal with source credibility from different perspectives. For example, some studies concern factor models that indicate other dimensions of source credibility such as competence, trustworthiness, dynamism, and authoritativeness dimensions [33], [53], [33]. Other studies link the role of source credibility to persuasion processes, with receivers persuaded to a greater degree by sources they perceived to be credible whether or not they were so [11]. This reflects the question posed in the introduction, concerning the believability of company reports that later become part of accounting scandals, as do later studies into attitude changes that indicate highly credible sources usually led to more behavioural compliance than do low-credibility ones [54].

Studies dealing with source credibility can take three perspectives: factor models, measures of levels of persuasion, and changing attitudes. Each perspective faces specific criticisms which apply equally to source credibility theory. For example, factor model studies are criticized for selecting scales haphazardly, using similar names for factors containing different scales, and using certain credibility factor structures. Factor models often fail to indicate whether the receivers when determining credibility use all the factors equally or prioritise [55]. Persuasion studies need to recognise that there are roles for message, channel, and receiver, and not just the communicator, and that all have responsibilities within persuasive communication processes [56], whilst in attitudinal studies, although it seems obvious that a more credible source would be much more likely to affect the attitudes of others, many studies have also revealed no relationship between attitude change and source credibility [56].

Acknowledging these potential limitations in future studies employing source credibility theory, it is suggested that credibility should be used not only to refer to the communicator (management) but also to refer to the messages (both financial and non-financial disclosures), the channels (annual reports, web pages, conferences call and so on), and the receivers (users). It is also suggested that the focus is not on persuasiveness communication which aims to change attitude but on informative communication - communication that aims to create awareness and deep understanding, and enables receivers to form and inform opinions. The focus is then information-related outcome variables such as perceived information quality and information selection, rather than persuasion-related variables such as change attitude. Reference [57] indicates that the informative communication can be considered effective when receivers regard the message they receive to be valuable for the purpose of their own opinion formation. Future studies of credibility could take a social psychology perspective which treats credibility as a perceptual variable, that is one where credibility is not an objective property of a source or a piece of information but is instead a subjective perception on the part of the information receiver. Thus, there is an emphasis on audience perceptions of credibility rather than on the objective credibility of a source or piece of information [20].

In practical terms, one way in which source credibility theory could be applied is in the consideration of why investors and other users are persuaded by the financial reports of certain companies which then fail, or why they choose to invest in a fraudulent business. Another application would be to understand why in some cases investor-analysts choose not to use financial reports directly but choose to rely on other sources or a package of sources. Using the source credibility theory framework, one can design quantitative studies that cover a number of variables or qualitative studies based on in depth interviews, structured around the dimensions of credibility. The key point is that both the sender and receiver, the message and the channel, are implicated in source credibility. The implications for preparers, auditors and standard setters are whether one tends toward preparing financial reports that have an aura of credibility (following on the Aristotlian notions of persuasion for political purposes) that is augmented or diminished by dissemination through different channels, or whether there is a drive towards 'fair representation'. Credibility is implicated in the underlying question of whether users can recognise a 'fair representation' or need other rhetorical devices to be convinced. Indeed, credibility is one dimension of the question, 'to what extent can a fair representation be achieved'? There is potential for financial reporting to be regarded as advertising, as Reference [5] implies and to some extent, the new impression management slant in accounting communication follows this idea [58].

VI. CONCLUSION

The purpose here has been to examine the role of credibility in achieving successful communication processes in financial reporting and to suggest a theoretical framework based on source credibility theory that can be used to design research exploring credibility as a dimension of communication in financial reporting. Credibility is shown to be multidimensional, and successful communication processes are taken to be those in which users are enabled to make useful decisions, although scope exists to challenge the concept of decision-usefulness, in the sense that what makes financial reporting credible may not be the content or inherent value of information but some other factor. In addition, the framework proposed drives researchers towards considering the financial reporting process holistically, examining senders, receivers, channels and noise, and not simply factors but levels of persuasion and changes in attitude. If financial reporting is the product, and users are the audience, source credibility theory potentially offers another means of understanding why audiences might be more persuaded by one means of financial reporting than another.

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Author:

Mostafa H. Alsohagy is a Lecturer of Accounting at the University of East London, UK. He received his MRes from Essex University, UK. His main research interests are in corporate communication and investor relations activities.