The Communicative Effectiveness of Market Risk Disclosures in the Annual Report of Financial Firms: Evidence from an Understandability Study

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ABSTRACT

The study seeks evidence on the understandability of the textual narrative of market risk information by using the Cloze Procedure. Based on Bormuth's 57 per cent cloze criterion reference point, the results show that the narrative is less understandable. Compared to other narrative from the same section of Management Discussion and Analysis, the market risk narrative is more difficult to understand. The implication of these results is that market risk narrative is not accessible for unsophisticated readers. In addition, firms that have a higher level of derivatives activities are found to write market risk narratives in a more understandable manner than less active ones. The management of these active financial firms therefore should be more careful about their communication effectiveness. This group of firms which is also big in terms of asset size is more likely to commit resources toward presenting an understandable and effective message to intended readers.

ABSTRAK

INTRODUCTION

There has been quite extensive literature on the importance of market risk information for external users of annual reports (e.g., Basle Committee 1994; Casson 1996; USGAO 1994; Young 1996). However, rather surprisingly, no one has ever gone further and studied the information about market risk from a communication perspective, specifically on its communicative effectiveness. The present study attempts to examine the effectiveness of financial firms dealing with financial derivative instruments in communicating information about market risk, by investigating the understandability of the narrative. Then, this study will also attempt to compare the results with the measured understandability levels of other narratives and observe relationships with other variables related to financial firms.

The remainder of this paper is divided into six sections. The following section discusses the importance of understandability. An explanation of cloze procedure follows in the third section. The fourth section reviews publications related to understandability studies and develops the research hypotheses. The fifth section explains the experimental methodology. The results are analysed in the sixth section. The paper ends with the conclusions in the seventh section.

MARKET RISK AND THE IMPORTANCE OF UNDERSTANDABILITY

Market risk arises due to changes in market price and in interest rate and foreign exchange rate fluctuations that may result in a decrease in the market value of a financial instrument. Market risk disclosure, like other information disclosed in the annual report must be understandable to make it useful for decision making. For information to be useful, it must be capable of being understood (CICA 1991). Statement of Financial Accounting Concepts No. 2 includes understandability as a user-specific quality that helps users perceive the significance of information.

The benefits of information can be increased by making it more understandable and, hence, useful to a wider circle of users (FASB 1980).

Parker, Ferris, and Otley (1989) in explaining the importance of understandability, mention that accounting information which is not understandable, for example, because of excessive use of technical jargon, limits the social accessibility of financial reports to the intended audience. Social accessibility refers to situations where certain message decoding skills are not available to a sector of the potential audience, thereby precluding effective communication.
CLOZE PROCEDURE

The cloze procedure is one of the techniques normally used to measure understandability. Although there are other techniques available, for example, true-false, multiple choice, fill-in, etc., a thorough search of the literature reveals that the cloze procedure is the most acceptable technique.

The cloze procedure was first developed by Taylor (1953) as a new psychological tool for measuring the effectiveness of communication. The cloze concept is derived from the term “closure” which is borrowed from the gestalt school of psychology. According to Atkinson, Atkinson, Smith, and Bem (1993) this school of psychology developed as an attempt to explain the complex phenomena involved in human perception. The psychological approaches developed to that date seemed at a loss to explain the difference between what actually was occurring (sensations) and what human beings tend to perceive. For example, what in reality, is a series of individual pictures, rapidly shown and varying only slightly, is perceived as a picture with movement. A mosaic is really a large number of individual pieces of material, yet it is perceived as a picture. Through a study of complex perceptual phenomena, the gestalt psychologist arrives at a series of perceptual laws, one of which is the law of closure which stated that when a familiar object is presented with some detail lacking, there is a psychological tendency to see that object as a whole unless a deliberate attempt is made to find a missing part.

From this concept, Taylor (1953) infers that the same psychological tendency would exist with respect to written materials, that is if there are missing pieces, there would be a natural psychological tendency for people to fill in the gaps to try to achieve a complete whole.

Cloze procedure, if applied to reading, requires the subject to fill in a gap, usually a whole word, which has been omitted in the text. In order to do this the subject must complete the language pattern of the writer by filling the gaps, e.g., by supplying “looks” in “The boy ........ through the window”. In order to complete such blank in an extract from a passage, the reader must be able to react according to a number of criteria:

1. Select a word according to grammatical rules.
2. Select a word with the correct meaning.
3. Choose a word that fits in best with the language patterns and vocabulary employed by the author.

The cloze procedure involves accuracy in that the reader cannot hope to fill in the blanks if he or she cannot recognise the majority of words given. It requires a full understanding of the text and therefore comprehension.
LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

PREVIOUS LITERATURE ON UNDERSTANDABILITY OF ACCOUNTING NARRATIVES

Although the cloze procedure was originally introduced as a technique for assessing reading comprehension and was recommended for the classroom teacher to adopt, its uses as an evaluation tool for reading have expanded in many directions over the past two decades. There are at least nine empirical published studies that assess the effectiveness of communicating accounting information by adopting a cloze procedure. Four of these (Adelberg 1979; Adelberg & Lewis 1980; Smith & Taffler 1992a, 1992b) specifically focus on the accounting information in annual reports. None of the studies examines the understandability of market risk narratives.

The studies by Adelberg (1979), Adelberg and Lewis (1980), and Smith and Taffler (1992a, 1992b) concluded that accounting information is not well understood. Adelberg (1979) conducts the first published cloze-based study of corporate annual reports using a questionnaire survey of professional accountants. A non-random sampling plan was used to select a total of sixteen corporations. Adelberg uses the cloze procedure to measure the understandability of four different types of narrative disclosures:

1. Standardised footnote (i.e., the footnote required by Accounting Principles Board Opinion No. 22 “Accounting Policies”).
2. Non-standardised footnote (i.e., the footnote required by Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5 “Accounting for Contingencies”).
4. Qualified auditor’s report.

Of the four types of message tested, the management’s analyses of operations and standard format footnotes are not understandable mostly because they contain technical terminology and numbers, and make references to specific financial statement items and amounts. The mean cloze scores for management’s analyses of operations is 56.6 per cent, for standard footnotes it is 58.4 per cent, for non-standard footnotes it is 61.4 per cent and for qualified auditors’ reports it is 64.3 per cent. Based on the Bormuth (1968) 57 per cent cloze criterion level, Adelberg concludes that, management’s analyses of operations and standard format footnotes do not communicate to sophisticated users.

Adelberg and Lewis (1980) conducted a laboratory experiment and tested four different types of statement to 20 volunteer audit seniors. The four statements selected were:
I. Bangor Punta Corporation’s note prepared to comply with APB Opinion No. 22, Disclosure of Accounting Policies.

2. The Anaconda Company’s note prepared to comply with Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.


4. Allegheny Power Systems’ qualified auditor’s report prepared to comply with the American Institute of CPAs fourth standard of reporting.

Initially, the 20 audit seniors were tested using the original statements. The results showed that narrative disclosures were not well understood. Then the statements were rewritten to improve their understandability. The results indicated that all the rewritten excerpts were better understood than the originals. The average understandability scores, were greater than the 57 per cent criterion level. This indicates that, on average, the rewritten passages do communicate effectively to these sophisticated users.

Smith and Taffler (1992a, 1992b) studied the understandability of accounting narratives on two different groups of users, accounting undergraduates and accounting practitioners. The narratives are based on extracts from the chairmen’s narratives of failed and non-failed companies from 1978 to 1985. The results showed that the practitioners’ scores range from 43.5 per cent to 72.9 per cent across 18 tests with a mean of 57.5 per cent, as compared with the students’ range of 33.2 per cent to 62.7 per cent with a mean of 48.5 per cent. For the accounting undergraduates, they failed to understand 10 out of 18, and 15 out of 18 passages, respectively, when measured against Bormuth’s (1968) 57 per cent cloze criterion reference point.

UNDERSTANDABILITY OF MARKET RISK NARRATIVE

Financial derivative instruments and market risk measurement methodology are new and the terminology involved may be too technical and sophisticated for even the sophisticated users. Literature on accounting and finance agree that financial derivative instruments are new and complex. Due to their complexity, many people including some senior managers do not really understand these instruments (“Taming the Derivatives Beast” 1992; “Waking Up” 1992). This lack of understanding about the instruments has made many firms rely on the knowledge of specialists (Lipin 1993).

Building on the previous research on understandability, this study attempts to extend the focus of previous studies by examining the understandability of market risk narratives. In the case of market risk narratives, it is possible to
hypothesise that these narratives are not very understandable (based on Bormuth’s 57 per cent cloze criterion reference point). The expectation is that, there are technical terms related to financial derivatives and many of those terms are very sophisticated. The excessive use of such terminology may be reflected in the understandability levels of the market risk narratives. We, therefore, propose the following hypothesis.

**Hypothesis 1: Market risk narratives are not well understood.**

**DIFFICULTY OF UNDERSTANDING MARKET RISK NARRATIVE COMPARED TO OTHER NARRATIVES**

In the previous literature, there is no published research comparing any narratives within the same section. Therefore, it seems prudent to test the difference of readability levels of market risk narratives against the rest of the narratives within the same section. In comparing market risk narrative disclosures with other narrative disclosures within the Management Discussion and Analysis sections, we can expect that the market risk disclosures are more difficult to understand. This is because most of the disclosures concern two items:

1. Financial derivative instruments.
2. The methodology the particular financial firm uses in market risk management, i.e., the Value-at-risk methodology, a method of assessing risk that uses standard statistical techniques routinely used in other technical fields.

Unlike the rest of the narrative disclosures in the management discussion and analysis, these messages are written using words which are not customarily used in daily business or financial reports. The following hypothesis is, therefore, proposed.

**Hypothesis 2: Market risk narratives are more difficult to understand as compared with the other narratives within Management’s Discussion and Analysis section.**

**UNDERSTANDABILITY OF MARKET RISK NARRATIVE AND ITS RELATIONSHIP WITH NOTIONAL AMOUNT OF DERIVATIVE INSTRUMENTS**

One particular study examines the relationships between understandability level and the financial variables of companies. Adelberg (1979) tests for statistical significance whether level of understandability of the type of message varies directly with the change in earnings per share from 1974 to 1975 of the source corporation. The tests, using Pearson Product-Moment correlation, show that
managements' analyses of operations and standard format footnotes reveal no relationship between understandability and performance. A similar test of relationship between the understandability of nonstandardised messages and performance is statistically significant (r = .22, p < .01). According to Adelberg, this supports the "management oriented" approach to financial reporting, and implies that managers are influenced, perhaps unconsciously, by a "good" year or "bad" year when they write their non-standardised narrative disclosures.

To extend the findings of Adelberg's study, it is possible to formulate a hypothesis about the relationship between the understandability level of market risk narrative and the derivatives trading activity of the financial firm. The level of a financial firm's activity as measured by the notional amount, might also have an important influence on the understandability of the market risk narrative. As a financial firm becomes more active, it should have more concern for the level of understandability of the narrative disclosures especially those related to derivatives. According to Dolde (1996) there is a close relationship between the derivatives trading activity and the firm size. In his study he finds that the majority of users of derivatives for risk management seem to be large firms. The size of the financial firm might be reflected in the transparency of the accounting disclosure. The management of the big financial firms will therefore be more careful about their communications, and will be more likely to commit resources to presenting an understandable and effective message to the intended report readers. The following hypothesis is, therefore, proposed.

**Hypothesis 3:** The level of understandability of market risk narratives correlates positively with the notional amount of derivative instruments.

**UNDERSTANDABILITY AND LANGUAGE USED**

Since none of the previous studies on understandability has looked into the relationship between understandability level and the first language of the country where the financial firm is based, it is important to formulate a hypothesis in relation to this point:

**Hypothesis 4:** There is a relationship between the first language of the country where the financial firm is based and the understandability level of the report narrative.
EXPERIMENTAL METHODOLOGY

The objective of this experiment is to investigate the understandability levels of the subjects on accounting information narratives and test the research hypotheses. The data for the study is obtained by conducting cloze tests of the accounting narrative disclosures from the annual reports of financial firms that deal with financial derivative instruments. The details of how the data is collected are discussed next.

SAMPLE SELECTION

The annual reports are requested by e-mail, letter or telephone. A sample of 40 financial firms is selected at random from 80 major dealers or endusers of financial derivatives received. All the financial firms are major banks or securities firms in their respective countries. From this sample of 40 financial firms, another selection is made by selecting annual reports which contain market risk discussion in the Management Discussion and Analysis section. See Table 1 for the sample selection process.

<table>
<thead>
<tr>
<th></th>
<th>Bank</th>
<th>Securities Firm</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual Reports Received</td>
<td>86</td>
<td>15</td>
<td>101</td>
</tr>
<tr>
<td>Involved in Derivatives Activity</td>
<td>70</td>
<td>10</td>
<td>80</td>
</tr>
<tr>
<td>Randomly Selected (Every second is selected)</td>
<td>35</td>
<td>5</td>
<td>40</td>
</tr>
<tr>
<td>Disclose Market Risk Information in MD&amp;A Section and Contain Market Risk Narrative &gt;200 words</td>
<td>12</td>
<td>0</td>
<td>12</td>
</tr>
</tbody>
</table>

MATERIALS

Two passages from the management's discussion and analysis were selected: one relates to market risk, and the other passage was selected at random. All the narratives must come from the management's discussion and analysis section in order to make a systematic comparison with other passages within the same section. In addition, the narratives should also comprise at least 200 words. This is important in order to have 40-60 deletions. The criterion reduces the number of financial firms under consideration from 40 to 12, and also excludes all the securities firms. Taylor (1953) suggests that a 50-item cloze test provides a sufficient sample for a stable score. However, Miller and Coleman (1967) use 30 deletions in each of their validation studies.
In constructing cloze tests to be applied to the narrative disclosures contained in annual reports, we choose to delete every fifth word. This is the most common pattern used. One reason is that if there are fewer than four words between deletions, completion of a blank becomes more dependent upon previous blanks. This is undesirable, since if a person misses an earlier blank he is almost certain to miss some later ones for this reason alone (Klare et al. 1972).

A 5, 10, 15 ... word deletion is used as recommended by Klare et al. (1972) because it gives the subject four words on each side of the first blank to help him. The first sentence is left as it is without mutilation in order to help the subject.

A word is usually defined by the blank spaces separating it from other words (e.g., U.K, and Value-at-risk would all be single words). Numerals are deleted as a unit unless they are spelled out. Each deleted word is replaced with a standard-sized blank.

SUBJECTS

A total of 200 academics involved with teaching and/or researching in the field of finance at higher institutions from all over the United Kingdom were used as subjects. Their names and institution addresses were selected at random from The British Accounting Review Register (Gray & Helliar 1996).

TEST ADMINISTRATION

Each subject is mailed a test package consisting of the following.

1. A personalised covering letter which explains the nature of the research project and the importance of their participation.
2. An instruction sheet (see Appendix A).
3. A cloze test (see Appendixes B and C for a sample test).
4. A self-addressed return envelope (100 of them are stamped).

For the cloze test, each subject received two textual messages, a market risk narrative disclosure and another narrative. Both messages are from the same source of information (a financial firm) selected at random from the twelve financial firms.

Stamped self-addressed return envelopes are enclosed because Scott (1961) finds this strategy produces a higher response rate. Subjects are expected to spend about 20 minutes completing the test. This is based on pilot runs of the test with a group of 10 accounting and finance research students.
SCORING THE CLOZE TESTS

A subject’s response is scored as correct when it gives the exact word deleted. Words with spellings errors are considered correct as long as it is evident that the respondent intended to write the word originally deleted. The decision to accept verbatim (exact replacement) scoring is based on a considerable amount of experimental evidence as well as practical considerations (Bormuth 1968). The scores are graded according to benchmark criterion reference point of 57 per cent.

RESULTS

As shown in Table 2, there are 78 responses out of the 400 tests mailed (39 out of 200 subjects) giving an overall response rate of 19.5 per cent. The response rate, although low, is more than reasonable for a mail survey. The response rates of previous cloze-based studies ranged from 17.8 per cent (Adelberg 1982) to 22 per cent (Adelberg 1979). Of these respondents, 31 of them are from the subjects provided with stamped self-addressed return envelopes.

However, we cannot be sure that the responses are representative of the original sample drawn. To deal with this potential non-response bias, the method used by Oppenheim (1978), which compare early respondents with late ones, was employed. By following his suggestion, mean cloze scores are calculated for each test (for market risk narrative and the other narrative) for the first 19 respondents and for the last 20 respondents. Next, a $t$-statistic is

<table>
<thead>
<tr>
<th>Financial Firm</th>
<th>Market Risk Narrative</th>
<th>Other Narrative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>2</td>
<td>4</td>
<td>4</td>
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<tr>
<td>3</td>
<td>3</td>
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<td>4</td>
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<td>5</td>
<td>3</td>
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<td>6</td>
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<td>9</td>
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<td>10</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>11</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>12</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>39</td>
</tr>
</tbody>
</table>
calculated for each test pair (early respondents and late respondents) in order
to test for significant difference between the means. The results show that
both means (relating to market risk and other narratives) of the 19 pairs are
not significantly different at the .10 level. Therefore, a non-response bias
probably does not exist.

Table 3 shows the scores of cloze test results for market risk narrative. The
mean score for the market risk narrative is 54.65 per cent, hence lower
than the 57 per cent minimum cloze score criterion suggested by Bormuth
(1968) to constitute understandability. Therefore, Hypothesis 1, which states
that market risk narratives are not well understood by sophisticated users is
supported. This finding is consistent with previous research on the under-
standability of accounting narratives in annual reports (e.g., Adelberg 1979;
Adelberg & Lewis 1980).

TABLE 3. Cloze Test Results for Market Risk and other Narratives

<table>
<thead>
<tr>
<th>Financial Firm</th>
<th>Market Risk Narrative</th>
<th>Other Narrative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>55.20</td>
<td>61.00</td>
</tr>
<tr>
<td>2</td>
<td>50.00</td>
<td>51.50</td>
</tr>
<tr>
<td>3</td>
<td>56.33</td>
<td>61.67</td>
</tr>
<tr>
<td>4</td>
<td>52.00</td>
<td>65.00</td>
</tr>
<tr>
<td>5</td>
<td>60.00</td>
<td>58.00</td>
</tr>
<tr>
<td>6</td>
<td>50.00</td>
<td>62.00</td>
</tr>
<tr>
<td>7</td>
<td>42.00</td>
<td>54.60</td>
</tr>
<tr>
<td>8</td>
<td>65.00</td>
<td>70.00</td>
</tr>
<tr>
<td>9</td>
<td>46.33</td>
<td>51.67</td>
</tr>
<tr>
<td>10</td>
<td>58.00</td>
<td>63.00</td>
</tr>
<tr>
<td>11</td>
<td>60.00</td>
<td>72.00</td>
</tr>
<tr>
<td>12</td>
<td>61.00</td>
<td>59.00</td>
</tr>
</tbody>
</table>

Hypothesis 2 expresses that market risk narratives are more difficult to
understand as compared with the other narratives within Management’s
Discussion and Analysis section. This hypothesis is tested by comparing the
results of the cloze scores of respondents for market risk narratives and other
narratives. Referring to Table 3, it can be seen that the market risk narrative
is more difficult to understand as compared to the other narrative within the
same section. The average cloze scores for the market risk and other
narratives are 54.65 per cent and 60.79 per cent respectively.

The difference in narratives complexity between market risk and other
narrative is then tested using the paired-samples t test. The results show that
they are statistically significant at (p < .002). Therefore, these statistical tests
support Hypothesis 2.
In order to test Hypothesis 3, the variables are tested using the Pearson product-moment correlation coefficient (Pearson’s r) to determine the relationship between market risk narrative understandability scores and other variables. The results reveal that the notional amount of financial derivatives are statistically significant at \( p < .05 \) (\( r = .61 \)). Therefore, Hypothesis 3 is supported. This finding provides some evidence to support the theory that financial firm actively involved in the derivatives activity are concerned about the understandability level of the market risk information disclosed in the annual report.

Hypothesis 4 expresses that there is relationship between the first language of the country where the financial firm is based and understandability level. In other words the first language of the country in which the financial firm is does influence the readability level of market risk narratives written in English. In order to test Hypothesis 4, using on the Bormuth (1968) cloze score criterion, we divide the scores into two categories; “understandable (more than 57 per cent) and less understandable (below than 57 per cent). We also divide the scores into two groups with respect to language:

- Group A: financial firms which are based in a country where English is the first language;
- and
- Group B: financial firms which are based in a country where English is not the first language.

The summary of cloze scores for market risk narratives from English and non-native English speaking preparers shows that the average cloze score for financial firms in English speaking countries is 55.5 per cent compared to the average for non-native English speaking countries which is 53.47 per cent. Then we test this hypothesis using the Fisher Exact Test, since the expected frequencies of the test are less than 5. The Fisher Exact Test shows that the relationship is not significant \( p > .10 \) (1-tailed). The results suggest that the first language of the preparers does not have a significant influence on the understandability of market risk information and the results do not support Hypothesis 4.

**CONCLUSIONS**

The study has sought to examine the understandability level of market risk narrative disclosures in the annual reports, using the cloze procedure. Twelve financial firms which has international dealings with financial derivative instruments were selected for this field experiment.
The study finds that the mean *cloze* score for subjects tested using a market risk narrative is 54.65 per cent. Based on the Bormuth (1968) *cloze* score criterion, theoretically the market risk narrative is not understandable for sophisticated readers. The implication of this result is that the narrative is almost certainly inaccessible for unsophisticated users. According to Chang, Most, and Brain (1983) and Lee and Tweedie (1975), unsophisticated users of accounting information rely almost exclusively on the financial narrative in their use of financial reports.

Financial firms must be concerned with the importance of communicating information about market risk effectively. Financial report preparers should acknowledge that all the information in the annual report should be understandable for the majority of readers (Parker 1986). Financial firms should also realise that the users of their annual reports include account holders or customers who possess different levels of knowledge and experience. This major user group should not be deprived, through lack of understandability from access to such important information, since it may have catastrophic results for their banks.

The results from this study show that financial firms should also move toward improving the understandability level of their narrative. Although difficult, as there are no special guidelines that may be followed, Adelberg (1979, 1982) suggests that the narratives may be improved by trial and error revisions. To implement this they could use *cloze* procedures to provide feedback via field trials of the understandability levels of early drafts of market risk narratives. If the scores compare unfavourably with the 57 per cent criterion level, drafts should be revised until the scores of subsequent *cloze* tests meet this criterion.

The findings from this study also show that the understandability levels of market risk narratives produced by financial firms in countries where English is the first language is not significantly different from that of narratives produced by financial firms in countries where English is the second or third language. This is probably that in the latter countries, English is more acceptable and commonly used in business communication and in social life. For example, in Malaysia, although Bahasa Melayu (Malay Language) is the national language, English is preferred language of business and reporting. However, on discussing this issue, we may also not disregard the possibility that the English version of annual reports are quite possibly translated by someone for whom English is a first language.

**LIMITATIONS OF THIS STUDY AND FUTURE RESEARCH**

In relying on the results of this study, it is important to bear in mind the limitation of *cloze* procedure. As highlighted by Jones (1997), there are legitimate concerns about the *cloze* procedure's measurement of comprehension,
its validity, and the precise meaning of cloze score. Therefore, future research is needed to establish how well the cloze procedure actually does measure the understandability of accounting narratives, and to determine appropriate criterion reference scores for accounting narratives. However, until a better technique is found, in the author’s opinion, the cloze technique remains a most excellent technique for assessing understandability.

In this study, the subjects selected were 200 academics from higher institutions in the United Kingdom. In order to enhance generalisability of the findings, the study should be repeated on other professional groups who have more experience, for example banking analysts. In addition, an increase in sample size to provide a higher response rate is suggested in order to verify the statistical validity of the findings.

NOTES
1. General readability formulas (Flesch Reading Ease Formula, Dale-chall Formula, Fog, Smog, Lix, etc.) are out of consideration because as many argue (e.g., Jones 1996, 1997; Smith & Taffler 1992a, 1992b) these formulas are not appropriate for the understandability study.
2. According to Sangha (1995), the amount does not mean the level of market risk a particular financial firm is exposed to, however, it is a useful indicator of the level of a firm’s activity in the derivatives markets.
The Communicative Effectiveness of Market Risk Disclosures

APPENDIX A

AN INSTRUCTION SHEET

The CLOZE Procedure

This part consists of two passages taken from annual reports of the same financial firm. The first passage is the market risk narratives and the second passage is selected at random. However, both passages are from the Management’s Discussion and Analysis section.

In both passages, a number of words have been omitted from the passages and replaced by a broken line. The broken lines are all of the same size and do not indicate the length of the words they replace. Your task is to replace the missing word with your best estimate of the precise word that has been deleted.

Your ability to make correct predictions will reflect your understanding of the passage and the ease with which the information is being conveyed. Use all the evidence that is available to you in the surrounding text, because the context in which successive deletions appear, and punctuation, will help to provide you the clues.

Some words will be easier to fill than others (e.g., words like “a”, “the”, “and”, “at”, “to”). Others will be more difficult, and you may need to reread whole paragraphs before you can confidently predict the deletions. Whether the prediction is easy or difficult, make the best guess that you can and avoid leaving any blanks.

For example:

Market risks arising from .......... activities and risks deriving .......... the impact of interest .......... fluctuations on the management .......... the group’s balance .......... are handled with .......... same method.

The correct predictions of each omission are:

Market risks arising from TRADING activities and risks deriving FROM the impact of interest RATE fluctuations on the management OF the group’s balance SHEET are handled with THE same method.
SAMPLE OF CLOZE TEST: MARKET RISK NARRATIVE

ADVANT BANK

MARKET RISK NARRATIVE

Market risk is measured and monitored on a daily basis through a value-at-risk (VaR) methodology. The VaR is defined the potential overnight loss from adverse market, with 97.5% confidence based historical prices and market. The quantification of market through a VaR methodology a number of key including confidence level for, number of days or history, the holding period, measurement of inter-business correlation, the treatment of risks the VaR methodology, including risk and liquidity risk. approach utilised for these methodological issues varies among.

Based on actual 1996 results, which capture historical among business units, 95% the variation in the daily trading results fell a $10 million band on the daily average for the year.

VAR not an absolute measure market risk under all for all products. In to VAR calculation, the performs alternative scenario analyses estimate the economic impact sudden market movements on portions of the trading. The results of these, along with the professional of experienced business managers, used to supplement the methodology and capture additional risks, including concentration, liquidity, and historical volatility and reliance risks.

In addition, VAR limits, the Bank’s risk management process incorporates other types of risk non statistical limits, and advisories. Non-statistical measures include open positions, basis point, position concentrations and position. Stop-loss advisories are also to advise senior management losses of a certain are sustained from a activity.
APPENDIX C

SAMPLE OF CLOZE TEST: OTHER NARRATIVE

ADVANT BANK

OTHER NARRATIVES

Credit risk for both lending-related products and derivatives and foreign exchange products represents the possibility that a loss may occur if a borrower or counterparty fails to honour fully the terms of a contract. Under the direction of Chief Credit Officer, risk and guidelines are formulated, and communicated throughout the organization; and senior credit executives, the major lines of business, are responsible for maintaining sound credit process, addressing issues, and reviewing the risks.

The Bank’s credit risk is an integrated process concurrently at the transaction portfolio levels. For credit business professionals formulate strategies, markets, and determine acceptable of risk. Credit executives with business originators during underwriting process to review to risk policies.

Portfolio lowers the Bank’s risk. In addition to the achieved by the expanse the Bank’s businesses, the diversifies by securitizing and credit assets such as, thereby seeking to avoid risk concentrations.

Loan Portfolio: The consumer commercial segments of the have different risk characteristics different techniques are utilised measure and manage their credit risks. The consumer risk management process utilises credit scoring and other methods to differentiate risk. Risk management procedures include both loan origination credit and loan performance quality. The consumer portfolio review also includes evaluating product-line, geographic diversity and consumer trends.

REFERENCES


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The Communicative Effectiveness of Market Risk Disclosures


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