

✓ good background information
✗ reference comparison embedded in text; no table

TEXT ANALYSIS IN FINANCIAL DISCLOSURES

Very relevant ✓

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ABSTRACT

Financial disclosure analysis and Knowledge extraction is an important financial analysis problem. Prevailing methods depend predominantly on quantitative ratios and techniques, which suffer from limitations like window dressing and past focus. Most of the information in a firm's financial disclosures is in unstructured text and contains valuable information about its health. Humans and machines fail to analyze it satisfactorily due to the enormous volume and unstructured nature, respectively. Researchers have started analyzing text content in disclosures recently. This paper covers the previous work in unstructured data analysis in Finance and Accounting. It also explores the state of art methods in computational linguistics and reviews the current methodologies in Natural Language Processing (NLP). Specifically, it focuses on research related to text source, linguistic attributes, firm attributes, and mathematical models employed in the text analysis approach. This work contributes to disclosure analysis methods by highlighting the limitations of the current focus on sentiment metrics and highlighting broader future research areas.

Keywords NLP · bag-of-words · Disclosures · Machine learning · EDGAR · Text analysis

1 Introduction and background

The steady flow of accurate and requisite information is essential for market efficiency. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates capital formation so important to the nation's economy. The October 1929 stock market crash plummeted public confidence in the markets. Investors and the banks who had loaned to them lost money in the following Great Depression. Based on the problems identified and proposed solutions, Congress passed the Securities Act of 1933 and the Securities Exchange Act of 1934. Through these acts, Congress created the SEC to restore investor confidence in capital markets by providing more reliable information and transparent rules.

To enhance and facilitate market information flow, the SEC offers the public a wealth of information, including the EDGAR database of disclosure documents that public companies file with the Commission.¹ This information empowers users to focus on the primary goal, i.e., financial modeling and security analysis, rather than on the information search and acquisition process.

Investors and analysts place great emphasis on security analysis and valuation because of the potential excess returns on capital and the downside risks. Research in this domain is potentially valuable because market inefficiencies can result in volatility and crashes, costing the economy billions of dollars. Analysts extensively use public firm's disclosures as a source of information.

¹SEC History <https://www.sec.gov/about/reports/sec-fy2015-agency-mission-information.pdf>

1.1 Accounting metrics models

Investors and analysts traditionally depended on quantitative information like accounting metrics for decision making. Multiple attributes of these accounting metrics drove this trend. FACC and accounting standards laid out what variables to be measured and disclosed. Gathering, processing, and analyzing these quantitative metrics was easy. Many free and commercial data providers automated data gathering, and publish these metrics.

However, these metrics do not always reveal the firm's current status and are not a good indicator of the future. They suffer from shortcomings like window dressing and retrospective focus

Window dressing Managers have the motivation and opportunity to report "desired" numbers than actuals. Managers know the financial ratios monitored by markets and regulators. Financial ratios can be fudged with temporary transactions, improving them at the time of reporting. Managers can use accounting discretion to value assets or to report inaccurate information. Accounting metrics analysis ignores the possibility of "contaminated source." As the purpose of the research is to identify material changes, and firms with negative material changes have more incentives to window dress, inaccurate disclosures is a significant concern. Sufficient evidence exists for window dressing through commissions and omissions. Rajan, Seru, and Vig (2015) showed that banks did not report information regarding the deteriorating quality of borrowers' disclosures in the run-up to the subprime crisis. Huizinga and Laeven (2012) said that banks overstated the value of their distressed real estate assets and regulatory capital.

Retrospective focus Accounting metrics analysis focuses on past performance. Investment and lending activities are forward-looking. Accounting information captures reality with lags. Some of the measures might be outdated by the time they are used in the analysis. Future forecasts based on these metrics also suffer from the same disadvantages.

Missing variables Firms are complex social organizations, and numerous social, political, and economic factors influence their performance. A firm's performance, survival, and profitability are affected by multiple factors. Companies do not measure all of these factors. Also, unless regulatorily mandated, firms might not report them. Regulators keep adding new reporting requirements to overcome this, but often fighting the last war and solving the past crisis. As a result, investors do not have access to some of the essential variables.

Window dressing, retrospective focus, and missing variables impact models based on accounting metrics. Regulators and investors who rely on such models have been impacted adversely in the past due to model failures (Rajan, Seru, and Vig (2015)). Hence researchers started paying more attention to alternative approaches like market based models and textual analysis of disclosures.

1.2 Market based models

Another approach for bankruptcy prediction is using market-based information. Classical efficient market theory and later option pricing theories assume that all available information is reflected in market prices. Under those conditions, accounting-based metrics do not have additional information over and above market prices. More specifically, a suitable market-based measure will reflect all available information about bankruptcy probability. Hillegeist et al. (2004) developed a prediction model based on market information, using option pricing theory derived implied volatility. This model outperformed the Altman (1968) z score model. Subsequently, numerous attempts have been made to replicate these results. Wu, Gaunt, and Gray (2010) provides a comparison of accounting and market-based models, along with others. They conclude that the Hillegeist et al. (2004) model performs better than the Z score model but is inferior to models that include non-traditional metrics. Similarly, Tinoco and Wilson (2013) concluded that accounting metrics based models and market-based models are complimentary.

1.3 Text analysis

Disclosure documents are rich with text information and provide a better insight into the future of the firm. Loughran and McDonald (2016) has demonstrated the relationship between disclosure text features and firm attributes.

However, unstructured text analysis remains difficult and still requires juggling many manual language processing tasks and technologies. Text information in disclosures prevents the computerized automation of security analysis. Engelberg (2008) noted that while text-based soft information has predictive power, this information comes at a higher cost due to processing challenges. As the information volume is high, analyst teams cannot promptly cope with it, let alone individual investors. Investors need the ability to extract reliable information and knowledge from disclosure texts with minimum manual effort.

Computational text analysis and Natural Language Processing (NLP) methods can help in extracting this information. Text analysis in finance can provide insights into the managerial motivation to disclose or obfuscate information, the circumstances for obfuscation, and impacted linguistic features. Natural Language Processing offers insights into the language models, information extraction, topic modeling, and new methodologies for measuring information content.

Researchers have started analyzing text content in disclosures recently. This survey covers the previous work in unstructured data analysis in Finance and Accounting. It also explores the state of art methods in computational linguistics and reviews the current methodologies in Natural Language Processing (NLP).

It consists of four sub-chapters as below.

1. EDGAR is the primary information source.
2. Text analysis in Finance.
3. Firm attributes.
4. Modeling approaches used.

2 EDGAR as the primary source of financial disclosure information

SEC regulations and oversight guide disclosure practices to increase transparency and reduce the likelihood of individual stock price crashes. To enhance and facilitate market information flow, the SEC offers the public a wealth of information, including the disclosure documents that public companies must file with the Commission.

While several information sources are relevant for the Financial domain, the Electronic Data Gathering, Analysis, and Retrieval system (EDGAR) filings represent the first-source database for investors doing fundamental research on security valuation. SEC introduced EDGAR in the early 90s and gradually made it mandatory for most listed companies to file their disclosures through EDGAR. Investors rely on EDGAR disclosures, and these disclosures are effective in improving market efficiency. Though firms file hundreds of types of disclosure forms, annual and quarterly filings (10-K, 10-Q), as well as material change filings (8-K), have the bulk of user attention.

If analysts can access EDGAR filings, they can incorporate the information into forecasts and security prices. While analysts have historically used financial disclosures, EDGAR's advent made it possible for individual investors to do the same. Christensen, Heninger, and Stice (2013) found that revisions in analysts' one-quarter-ahead earnings forecasts around SEC filings dates in both the pre-EDGAR and EDGAR periods were significant. However, the stock price reactions to SEC filings are meaningful only in the EDGAR period, indicating that individual investors can incorporate the information in their price expectation.

2.1 EDGAR filings- market reaction

Numerous other studies researched and established market reactions to SEC EDGAR filings. Stice (1991) studied the impact of early filings. Bühner and Möller (1985) assessed the information content of corporate disclosures relating to decisions to adopt a multi-divisional structure. Asthana and Balsam (2001) examined the effect of filing form 10-K on EDGAR when compared to the traditional method of filing. Yang (2015) studied the disclosure and valuation of foreign cash holdings. Li et al. (2009) found significant market reaction during quarterly reports if the filing coincides with the first public disclosure of earnings, although earnings releases do not subsume that for 10-K reports. You and Zhang (2011a) concluded that among large firms, investors under-react more to the information contained in 10-K filings than earnings announcements, and underreaction to earnings announcements tends to be stronger for small firms than large firms. You and Zhang (2011b) observed that investors use information from earnings reports and 10-K disclosures differently.

2.1.1 Delay in filings

Firms' inability to file disclosure on time has information content. Duarte-Silva et al. (2013) studied the market reaction to earnings delay announcements and concluded that these delays provide a signal of financial performance deterioration. Khalil et al. (2017) observed similar effects in bond markets as bond markets react negatively to late filing announcements of 10-Ks and 10-Qs. However, the cost of non-compliance with SEC filing requirements vary, based on whether the delay is due to a systems-related issue or not. Investors' ability to discern the reasons behind delays results in differential market response. Cao et al. (2010) investigated the reasons stated for delayed filings on Form 12b-25 and found evidence that negative market returns are associated with filing delays caused by Information System issues, SOX implementations, and SEC investigations.

Table 1: Top 20 EDGAR filings till Dec 2018

Description	Form.Name	Grand.Total
Changes in ownership	4	6,757,053
<u>Current report filing</u>	<u>8-K</u>	<u>1,549,474</u>
5% passive ownership triggers amendments	SC 13G/A	655,696
Initial Ownership Report	3	613,615
<u>Quarterly report</u>	<u>10-Q</u>	<u>574,774</u>
Definite materials	497	417,177
Curret report of Foreign issuer	6-K	379,844
5% passive ownership triggers	SC 13G	369,518
Change on prospectus	424B3	276,705
Quarterly hodings, institutional managers	13F-HR	238,794
Prospectus filed pursuant to Rule 424(b)(2)	424B2	236,485
5% active ownership triggers amendments	SC 13D/A	222,739
Changes in ownership amendments	4/A	217,095
Offering made without registration	D	211,275
Annual report on ownership changes	5	199,887
A correspondence	CORRESP	186,948
Upload Notification	UPLOAD	183,620
<u>Annual report</u>	<u>10-K</u>	<u>183,148</u>
Post-effective amendment	485BPOS	171,995
Summary Prospectus	497K	169,519

2.2 Non-periodic disclosures

Over time, the SEC expanded the items that firms have to report and accelerated these reports' timelines. Form 8-K, which became effective on August 23, 2004, is the "current report" companies must file to announce major events that shareholders needed to know. As a result, investors need not wait for periodic reports for time-sensitive information. However, Lerman and Livnat (2010) observed that this has not resulted in a reduction of information content in periodic reports. Market reactions to 8-Ks indicate that investors may still rely more on 10-K and 10-Q reports to interpret material events' effects.

Firms' inability to file Form 8-K on time may indicate internal control weakness. In a study covering a sample of 118,863 8-K filing event observations, Holder et al. (2016) found a negative relation between the likelihood of a material internal control weakness and the timeliness and compliance of 8-K filings. The market reacts to SEC 8-K filings on and between the event's date and the date of filing. Ben-Rephael et al. (2017) showed significant abnormal attention paid by institutional investors on both the filing date and the event date. The same is not the case with retail investors. Considering the high volume of 8-K disclosures and relatively less information content than periodic filings, retail investors might not be paying sufficient attention to the 8-K filing. Most retail investors use manual methods to extract information from EDGAR, and large volume is a hindrance. As most price discovery occurs during the pre-filing period when institutional investors pay attention, retail investors might be disadvantaged. The automatic processing of such filings for information extraction can benefit retail investors.

2.3 Edgar usage

While EDGAR is useful, there were concerns by stakeholders about the cost-benefit balance. To better understand the usage of EDGAR company filings, SEC started releasing EDGAR Log File Data Set. The Division of Economic and Risk Analysis (DERA) has assembled, and published information on all internet search traffic for EDGAR filings through SEC.gov, and current data covers the period February 14, 2003, through June 30, 2017. Researchers have studied the timing and investors' accessing patterns of financial filings. Investors request millions of filings from EDGAR each week, showing a high preference for 10-K, 10-Q, and 8-K, along with insider trading disclosures filed on Form 4.

The timing of investor requests indicates that investors commonly request historical disclosures filed in prior periods. This demand is high when the stock is under-performing, i.e., past and current abnormal stock returns are lower. Drake,

Roulstone, and Thornock (2012) found that investors access mandatory financial filings during news release periods, and the demand increases during times of negative news and increased uncertainty about the firm's business.

Jackson and Mitts (2014) demonstrated that investors' ability to access and process market-moving information before others results in trading profits. Based on EDGAR server access traffic from 2008-2011, Drake, Roulstone, and Thornock (2015) found that information acquisition via EDGAR positively influences market efficiency. Ryans (2017) analyzed the same data set from a different perspective and demonstrated the differences between human requests and financial robots.

Other research findings on EDGAR access traffic

- Average user accesses the database infrequently.
- Users access specific periodic filing types such as 10-K and 10-Q.
- Few users access EDGAR almost daily and access numerous filings.
- EDGAR activity is positively related with
 - corporate events
 - * restatements
 - * ~~earnings~~ announcements
 - * ~~acquisition~~ announcements
 - poor stock performance
 - EDGAR activity is distinct from other investor interest proxies and has unique information content.

A 10-K filing is a very long, complicated document, and investors need to spend hours comprehending the same. As a result, individual investors might be relying on analysts and secondary research products for the fundamental analysis. Loughran and McDonald (2017) found that the average publicly traded firm has its annual report requested only 28.4 total times immediately after the 10 K-filing. They concluded that investors generally are not doing fundamental research on stocks. The low number of access requests indicate the challenges of processing EDGAR filings and suggest the requirement for automatic information extraction and knowledge discovery.

By linking EDGAR server activity to analysts' brokerage houses, Gibbons, Iliev, and Kalodimos (2018) concluded that analysts rely on EDGAR in 26{} of their estimate updates. They found that fundamental research is associated with a significant reduction in analysts' forecasting error relative to their peers.

These studies indicate that investors and analysts access mandatory disclosures through EDGAR and the information discovery impacts price formation. They demonstrate the importance of fast processing of information as a delay in the order of seconds has a significant opportunity cost. Also, they show the difficulties in extracting data from EDGAR in real time, especially for retail investors. Considering that historical filings are frequently accessed, and firms file 2 million disclosures every year, automated information extraction is a must for timely dissemination and price discovery.

2.4 XBRL

To facilitate automated information extraction, SEC has adopted the eXtensible Business Reporting Language (XBRL) and enhanced the EDGAR database. SEC initiated XBRL in 2009 and mandated that all firms use XBRL by 2011. Later, it extended the due date to 2014. In XBRL, filers tag their financial statements with elements from a taxonomy that defines the reporting concepts so that the information consumers can understand XBRL files (Debreceny et al. (2011)). According to Henselmann, Ditter, and Scheir (2013), this enables the gathering of accounting numbers to be fully automatic in a database-like manner, which provides vast opportunities for financial analysis.

Numerous researchers studied the impact of XBRL across various aspects of the financial information environment, like market efficiency, price discovery, and volatility. Kim, Lim, and No (2012) findings show an increase in information efficiency, a decrease in event return volatility, and a reduction of change in stock returns volatility for 428 firms (1,536 10-K and 10-Q filings) post-XBRL disclosure. Their study also showed that XBRL mitigates information risk in the market, especially during increased uncertainty in the information environment. Mangold et al. (2013) analyzed a sample of 671 amended filings for XBRL from 2005 to 2011 and found a significant market reaction to the XBRL.

After initial years of XBRL implementation, there have been complaints by some Fortune 500 companies that XBRL filings have not proven useful and have advocated for the SEC to scale down its requirements. However, research continued to show the positive impact of XBRL. Analysts under-react to initial information releases if they expect subsequent follow-up disclosures to have better quality information. Dontoh and Trabelsi (2015) found that the market reacted significantly less to earnings announcements of firms that issued XBRL filings than a matched sample that

did not give filings. They also found that firms that issued XBRL filings exhibited significantly lower excess return volatility than non-filers and concluded that overall, XBRL has been useful in improving market efficiency.

Some researchers tried to develop tools to leverage XBRL information for identifying new information in the market. Henselmann, Ditter, and Scherr (2013) proposed abnormal digit distributions at the firm-year level to identify firms indulging in earnings management. Hoitash and Hoitash (2018) suggested a “count of accounting items (XBRL tags)” in 10-K filings as a measure of accounting reporting complexity (ARC). This complexity aspect can increase the likelihood of mistakes, incorrect GAAP application and ultimately lead to less credible financial reports.

2.4.1 Shortcomings of XBRL

While the above studies indicated the benefits of XBRL, researchers studied the complexity introduced by XBRL vs. the corresponding benefits. When SEC introduced XBRL, it believed that this new search-facilitating technology would reduce informational barriers and asymmetry that separate smaller, less-sophisticated investors from larger, more sophisticated investors. If larger investors gain significant benefits from XBRL through their superior resources and abilities, smaller investors will be disadvantaged, and information asymmetry is likely to increase. Blakespoor, Miller, and White (2014) studied this question and observed higher bid-ask spreads for XBRL adopting firms. While XBRL may have reduced investors' data aggregation costs, it may not have leveled the initial years' informational playing field.

The XBRL mandate intends to streamline the financial reporting pipeline by providing a standard dictionary for collecting, collating, and analyzing financial information on the Web. However, the current lack of suitable XBRL interoperability prevents the realization of the mandate's potential. SEC provided GAAP taxonomy for filing the reports in XBRL format. The U.S. GAAP taxonomy's design supports standard reporting practices and U.S. GAAP disclosure requirements. It also allowed the filer creates an extension element if taxonomy elements for each disclosure concept are not present. While appropriate extensions can provide decision-relevant information, unnecessary extensions, when suitable elements exist in foundation taxonomy, create redundancy and no information content. Debreceny et al. (2011) analyzed extensions made in a subset of XBRL filings between April 2009 and June 2010. It concluded that forty percent of these extensions were unnecessary, as semantically equivalent elements were already in the U.S. GAAP taxonomy. New concepts, many of which were variants of existing features, accounted for 30 percent of the extensions.

Value addition from XBRL-tagged data will materialize only if the XBRL statements are accurate and reliable. Bartley, Chen, and Taylor (2011) studied errors in XBRL filings and evaluated the accuracy of early voluntary filings. While improvements in the XBRL standard and related technology mitigate specific errors, other errors related to inexperience will persist.

The above results suggest that while XBRL has helped in information discovery, it has not yet delivered the intended benefits. Streamlining the financial reporting pipeline has remained a pipe dream. Also, considering that significantly more information is present in the form of text in disclosures, analysts cannot access it using traditional structured data analysis. Hence there is a need for unstructured data analysis.

This sub-chapter has demonstrated how EDGAR acts as a primary source of financial disclosures and how the SECs attempts to enable easy information extraction still suffer from shortcomings. The next sub-chapter will analyze how analysts have attempted to extract information from text using text analysis.

3 Text analysis in finance

This sub-section covers the previous work in unstructured data analysis in Finance and Accounting. Most of the literature of these fields talks in terms of sentiment. While researchers used dictionary-based methods, recent success has been more due to probabilistic techniques. The following literature review helps us identify which of the many statistically motivated options are best for this problem. Finally, this section examines several practical applications of the theoretical techniques relevant to current work. Analysts and individuals pay attention to text components of a firm's disclosures as company disclosures traditionally have been accompanied by narrative disclosures regarding the companies (Fisher et al. (2010)). Financial and accounting researchers have been paying attention to text analysis research problems, i.e., “Efficient use of narrative textual documents.” Prior research used different information sources like corporate textual disclosures in filings, accounting standards, and CEO statements for various purposes, such as forecasting future performance, dictionary development, and formalization (Loughran and McDonald (2016)).

As noted in the prior sections, financial reporting and disclosures' objective is to ensure the availability of information about firms' financial position to a wide range of users, including existing and potential investors, financial institutions, employees, and the government. Text analysis in Finance starts from the hypothesis that there is a relation between linguistic properties of disclosures and business performance (Smailović et al. (2018)). In recent years, text analysis in

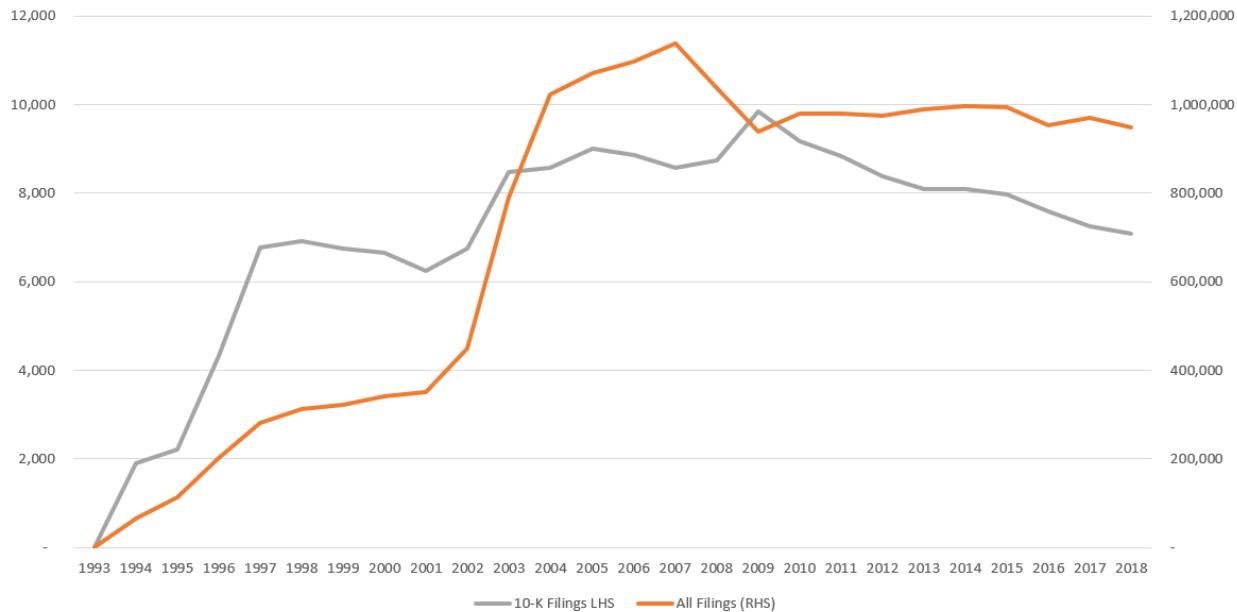


Figure 1: Number of annual EDGAR filings

Finance and accounting has seen a dramatic increase in attention. Increased availability of technology for storing and accessing data was the driver. This increased attention resulted in better methods to process a large corpus of texts in real time in other domains. Some of those methods have been attempted in Finance also.

The following sections contain a brief review of text analysis in Finance and accounting, structured into three parts.

- Content analysis: This part covers “sections and content from financial disclosures” that researchers studied. These sections are the “source of linguistic features” that explain the business performance. There are more than 200 types of disclosure forms, and each has multiple sections. Understanding text content used in research helps us understand the researchers’ objectives and the research gaps.
- Linguistic Properties: Covers “What features are extracted” from financial disclosure text. While linguistic properties can explain business performance, suitable methods have to transform the text into linguistic measures.
- Business performance attributes This part covers “Which aspect of business performance” the researchers tried to explain with linguistic variables.
- Statistical methodology: This part covers what types of statistical tools and methods used in the research



3.1 Content analysis

Communication between corporate management and various interested constituencies occurs continuously and in many forms. A traditional statutory-based formal communication vehicle is the corporate annual report. Although a less timely medium than other filings, the annual report comprises a comprehensive database of past corporate achievements, thereby facilitating the confirmation, revision, and formation of readers’ expectations about a company in which they have an interest (Courtis (1998)). The annual report will be more or less useful depending on the extent to which, among other things, its content is readable and understandable. One contemporary annual reporting trend is for management to employ more narrative disclosures as part of the overall communication package.

!!!

-annual report
-news
-historical price

A typical financial disclosure has many sections. Each section has relevance to one or many of the investor’s research questions. Extracting a relevant text segment is a computational challenge. Information extraction deals with the problem of identifying the required information and pulling from a source. The number of filings with EDGAR has exceeded 18mn as of Dec 2018. Figure 1 shows the filings trend over the year. With over a million new filings each year, manual analysts have reached their capacity limits in exploring this dataset. Systematic exploration of this dataset necessitates automation to overcome overload.

annual report → leaving “key words” driving share price movement
historical price aligned timeline logic reasoning

Apart from the large volume of filings, some of the filings are lengthy, further hampering analysts' ability to process and understand the information. A significant portion of text in financial disclosures like 10-K reports is under managerial discretion and depends on how firms respond to mandatory disclosure requirements. Other factors that influence the length of filings include firms operating complexity and disclosure redundancy. Cazier and Pfeiffer (2016) partitioned 10-K length into the portions explained by these factors. While disclosure redundancy and operational complexity explain roughly equal amounts of variation in 10-K size, the remaining content explains a higher proportion of variation supporting the managerial discretion theory. Due to this, analysts need to give enough consideration in identifying using sections of financial disclosures.

Researchers have approached this in different directions. Cong, Kogan, and Vasarhelyi (2007) used the income statement section of 10-K filings and a set of heuristic-based templates to train a system to process one type of EDGAR filings in a single configuration. Another approach is to construct domain-specific languages to provide modeling capabilities tailored to a specific domain. Li and Zhao (2014) introduced a domain-specific meta-modeling language with examples from different fields, including financial disclosures. Matthes and Coners (2015) evaluated two text analysis strategies - dictionary and statistical approach and concluded that they complement each other. Han et al. (2016) provides general data extraction and analysis resolution for mining the business knowledge from EDGAR. Focusing on each company's annual meeting date from the 'DEF 14A' form, they automatically scanned 546,451 documents and extracted 82,872 annual meeting date records of 10,417 companies. Topic modeling for comparative text analytics is another computational linguistic approach in banking. Chen et al. (2018) compared and evaluated multiple topic modeling approaches in analyzing U.S. banks' SEC filings by U.S. public banks and concluded that topic modeling could be useful in financial decision making and risk management.

Numerous research works have analyzed the complete content of disclosures. Hendricks, Lang, and Merkley (2017) examined whether textual attributes of firms' regulatory filings reflect CEO characteristics. Buchholz et al. (2018) concluded that CEO's narcissism explains the abnormal optimistic tone in financial disclosures.

3.1.1 Management Discussion & Analysis (MDA)

Management Discussion and Analysis (MDA) is a Part of a Firm's Overall Disclosure Package. As MDA contains new and useful information about the firm, investors use it for financial analysis purposes. Clarkson, Kao, and Richardson (1999) presented evidence regarding the usefulness of MD&A, and on disclosure quality. Foster and Hussey (2006) trained a proprietary algorithm to quantify companies' strategic orientation, based on semantic patterns within the MDA section of 70,000 10-K filings. Preparing MDA is time-consuming. Firms have an incentive to use a template to reduce the effort while remaining compliant with regulatory requirements. MDA information value diminishes if it does not change significantly, even after material changes at the firm. SEC expressed concern about in the late 2000s. Brown and Tucker (2011) studied year over year changes in MDA and introduced a measure for disclosure. They found that firms modify the MD&A more in the presence of more considerable economic changes, and the modification score is positively related to stock price responses. After initial research work on text-based models, other researchers evaluated if the text-based analysis has excess explanatory power over quantitative models. There is evidence that text-enhanced models are more accurate than models using quantitative financial variables alone. Bochkay (2014) explored methodologies for analyzing and incorporating text into quantitative models. Using regularized regression methods, they examined whether textual disclosures in the MDA help predict future earnings above and beyond traditional financial factors. They found that Firms with broader changes in future performance, adverse changes in future performance, higher accruals, greater market capitalization, and lower Z-scores have more informative MD&As, suggesting that MD&A content helps to reduce uncertainty.

Numerous other researchers analyzed MDA to explain future stock performance (Tao, Deokar, and Deshmukh (2018a), future returns, volatility, and firm profitability (Amel-Zadeh and Faasse (2016)), bankruptcy (Yang, Dolar, and Mo (2018)), going-concern (Mayew, Sethuraman, and Venkatachalam (2015), Enev (2017)), litigation risk (Bourveau, Lou, and Wang (2018)), and incremental information over earnings surprises, accruals and operating cash flows (OCF) (Feldman et al. (2008), Feldman et al. (2010)).

Another part of MDA that attracted research interest was Forward-looking statements (FLSs), especially from IPO prospectuses. FLSs provide prospective information about the company's future growth and performance. Tao, Deokar, and Deshmukh (2018a) evaluated the relationship between features extracted from FLSs and IPO valuation. They proposed an analytical pipeline for identifying FLSs and extracting linguistics features, including topics, sentiments, readability, semantic similarity, and general text features. They concluded that FLS features are more predictive for pre-IPO as compared to post-IPO valuation prediction. F. Li (2010b) found that firms with better current performance, lower accruals, smaller size, lower market-to-book ratio, less return volatility (lower MDA Fog index), and long history tend to have more positive FLSs. Also, the average tone of the FLS is positively associated with future earnings, even after controlling for other determinants of future performance.



3.1.2 Financial notes

Another important section in filings is Financial notes. It is a general practice for managements to explain large deviations, year on year changes, and material treatment changes through financial notes. Analysts use these notes to compute accounting adjustments to correct financial statements. This mechanism helps in incorporating this information into stock prices.

De Franco, Franco Wong, and Zhou (2011) examined financial statement notes in 10-K filings and observed that stock returns are positively related to accounting adjustments. They also found that equity analysts are likely to update target price estimates in proportion to an increase in the adjustments' magnitude. The revisions are consistent with the sign and extent of the adjustments. Amel-Zadeh and Faasse (2016) concluded that investors react in a timely and robust manner to textual characteristics of the MDA to textual attributes of the financial notes.

The above studies focused on accessing and extracting text information from EDGAR filings for further analysis. The following section covers what linguistic features have been studied, i.e., sentiment, tone, and readability.

3.2 Language analysis

This section surveys the independent variables used in the textual analysis of financial disclosures.

3.2.1 Sentiment

Sentiment analysis of firm disclosures involves an automated process of understanding management's opinion about various aspects of a firm's economic and financial prospects. Management opinions provide qualitative information on the entity's financial status apart from quantitative data. Investors and analysts consider and incorporate this information into financial decisions. Chen et al. (2011) built tagging models based on the conditional random field (CRF) techniques to study opinion patterns in U.S. financial statements. Others have studied the impact of corporate disclosure on credit risk valuation using news coverage and news sentiment. Based on 13 years of CDS data, Tsai, Lu, and Hung (2016) found a correlation between negative news sentiment and increased credit risk.

Sentiment analysis uses dictionaries to classify the tone of the words and then scores negative and positive word counts to measure the tone. Loughran and McDonald (2009) shows that word lists developed for other disciplines like Harvard Dictionary misclassify common words in the financial text. In a large sample of 10-Ks from 1994 to 2008, almost three-fourths of the terms identified as negative by the widely used Harvard Dictionary are words typically not considered harmful in financial contexts. Loughran and McDonald (2009) developed an alternative negative word list and five other word lists that better reflect tone in the financial text. They linked the word lists to 10 K filing returns, trading volume, return volatility, fraud, material weakness, and unexpected earnings. The research community has widely accepted these dictionaries for financial text analysis. Some of the other word lists used to measure the tone of financial are 1) a wordlist developed in Henry's (2006, 2008) analysis of earnings announcements (Henry Wordlist); 2) a wordlist from DICTION (DICTION Wordlist) software developed by Roderick Hart; and 3) a wordlist from the General Inquirer program (G.I. Wordlist) designed by social psychologist Philip Stone (Henry and Leone (2014)).

Unlike other domains, positive and negative sentiments have asymmetric information for investors. Due to their different implications for stock prices, trading volumes, and firm fundamentals, netting positive and negative sentiment measures results in significant information loss. Azimi and Agrawal (2018) found that both negative and positive sentiment measures explain variation in stock prices and trading volume at the time of disclosure. These measures also have predictive power for future profitability, cash holding, and leverage.

The textual sentiment of corporate disclosure is useful in forecasting corporate investment and financing decisions. Firms whose tone in 10-k filings is conservative are known to be risk-averse in their M&A actions. Ahmed and Elshandidy (2016) has concluded that firms with conservative disclosure tone make conservative acquisition choices. They are reluctant bidders, prefer stock-based acquisitions over cash-based deals, and experience abnormal low stock returns during M&A announcements.

Financial disclosures risk sentiment has implications for future earnings and stock returns. An increase in risk sentiment results in lower future earnings, and risk sentiment explains future returns variance. Liu et al. (2018) created and used 10-K risk-sentiment dataset for risk detection. Li (2006) constructed risk sentiment measure of annual reports using risk or uncertainty related word frequencies in the 10-K filings and tested the relation between the metric and firms' future returns. They found that firms with a larger increase in risk sentiment have more negative earnings changes in the next year. Also, firms with increased risk sentiment underperform relative to other firms twelve months after the annual report filing date. A risk sentiment-based long-short portfolio generated a 10% yearly Alpha, measured using the four-factor model, i.e., momentum and the Fama-French three factors. Gandhi, Loughran, and McDonald (2017) suggested using annual report sentiment as a proxy for Financial Distress in U.S. banks. They found that the annual

report's negative sentiment is associated with larger delisting probabilities. Sentiment also explains the odds of paying subsequent dividends, loan loss provisions, and lower future returns on assets.

Recent years have seen the usage of sentiment analysis as an input feature to supervised learning techniques. Rawte, Gupta, and Zaki (2018a) used sentiment analysis to predict bank failure. They combined word sentiment polarities and their count as a weighted feature vector for SVM and deep learning approaches. Tao, Deokar, and Deshmukh (2018b) constructed numerous linguistics features from Forward-Looking Statements (FLSs) like topics, sentiments, readability, semantic similarity to analyze pre-IPO predictability vs. post-IPO valuation.

3.2.2 Tone analysis

Tone analysis enquires whether the text content is optimistic or pessimistic in tone. The tone of the forward-looking statements in a firm's MDA explains future earnings and liquidity, even after controlling other predictors of future performance. F. Li (2010b) analyzed the relation between the tone of the forward-looking statements (FLS) in the MDA and the firm's future returns. They manually categorized 30,000 randomly selected FLS sentences on two dimensions tone and content. Content is classified based on the topic of the sentence, including profitability, liquidity, and operations. With this as training data, they classified the tone and content of about 13 million forward-looking statements. They found that better current performance and lower accruals are associated with higher positive forward-looking statements in disclosures. A critical aspect of language changes in usage also has information content. Feldman et al. (2008) and Feldman et al. (2010) measured the change in disclosure tone compared to the previous four filings and examined the incremental information content of tone Change. Their results indicate that short window market reactions around the SEC filing are associated with the MDA section's tone, even after controlling for accruals, OCF, and earnings surprises. The tone adds significantly to portfolio drift returns in the window of time. They also found that incremental information of tone change is more extensive for firms with weak information environment. Amel-Zadeh and Faasse (2016) found that changes in the MDA text and footnotes and differences between the two sections' tone predict negative future stock returns and operating performance.

Others have examined the relationship between the tone of management's 10-K filings and the likelihood of getting involved in an FCPA violation or litigation. Lopatta, Jaeschke, and Yi (2014) found that FCPA violators use more negative, uncertain, litigious, and complex language when disclosing financials than non-violators. They also show that managers make strategic use of language after FCPA prosecution by lowering their negative, uncertain, and litigious tone in 10-K filings. On the other hand, investors who bought into stocks based on management's optimistic projections may be disappointed by subsequent underperformance. So, the use of optimistic language in disclosures may increase litigation risk. Rogers, Van Buskirk, and Zechman (2011) examined the relation between disclosure tone and shareholder litigation. Based on tone measurements using general-purpose and context-specific text dictionaries, they observed that sued firms' earnings announcements are unusually optimistic relative to other firms in similar economic circumstances. This observation indicates that plaintiffs target more optimistic statements in their lawsuits.

In recent years, researchers have tried to study the relation between tone and more complex business attributes. Researchers tried to explain the business strategy, regulatory compliance, litigation risk, and management characteristics in these works.

Manager's optimism or pessimism in disclosures can impact the market's reaction to the information. Hendricks, Lang, and Merkley (2017) studied the relation between the Manager's tone or optimism in disclosures and subsequent firm performance. They observed founder-led firms have "excess" optimism relative to realized earnings and compared to non-founder-led firms. Buchholz et al. (2018) examined the relation between CEO narcissism and abnormal optimistic tone in financial disclosures. They defined "abnormal" as the tone unrelated to a firm's performance, risk, and complexity. In a sample of U.S. listed firms over 1992-2012, they observed that an abnormal, optimistic tone in 10-K filings is positively related to CEO narcissism.

Mayew, Sethuraman, and Venkatachalam (2015) stressed the importance of linguistic tone in assessing a firm's health. Using a sample of bankrupt firms between 1995 and 2012, they concluded that management's opinion about going-concern and the MDA's linguistic tone together predict whether a firm will go bankrupt. F. Li (2010a) linked self-serving attribution bias ("SAB") to the Manager's tone in disclosures. FLS of managers with more SAB have smaller variations in the tone (e.g., positive versus negative), and their earnings forecasts tend to be overly optimistic. Firms whose managers have more SAB have higher investment-cash flow sensitivity and experience more negative market reactions around acquisition announcements.

Research results suggest that the tone ambiguity of a firm's financial disclosures is related to managerial information hoarding. Shareholders of firms with less readable and more ambiguous annual reports suffer from a lack of transparency and bear the increased cost of external financing. Ertugrul et al. (2016) investigated the impact of a firm's annual report readability and ambiguous tone on its borrowing costs. They find that firms with a higher proportion of uncertain and

weak modal words in 10-Ks have stricter loan contract terms and greater future stock price crash risk. Lim, Chalmers, and Hanlon (2018) analyzed the relationship between a firm's business strategy and the tone used in disclosures. They find that prospectors display more negative and uncertain styles, while defenders exhibit a more litigious manner in their 10-Ks. Ji and Tan (2016) studied changes in firms' disclosure policies in response to labor unemployment concern using the tone of 10K and 10 Q filings and found it as an essential consideration for corporate discretionary disclosure. Sandulescu (2015) investigated the relations between disclosure tone, insider trading, and returns and found that the net disclosure tone predicts the insider purchase ratio (purchases scaled by the sum of purchases and sales) and abnormal returns after controlling for past purchases, return volatility, and firm characteristics.

Researchers also tested the validity of linguistic methods borrowed from other domains. "Diction" is frequently used to assess the tone of business documents. Loughran and McDonald (2015) argued that Diction is not suitable for the same. More than two-thirds of the Diction optimistic words and Diction pessimistic words in a sizeable 10-K sample are likely misclassified. For example, words like respect, security, power, and authority will not be considered positive by readers of business documents. These are frequently in disclosures. Also, nearly half the pessimistic 10-k word counts are "not" and "no." The authors compared Diction and Loughran-McDonald (2011) and believed that the latter is better at capturing tone in the business text.

3.2.3 Readability

Readable disclosures and reports provide simple, straightforward, and homogenous information that is understandable by all investors. Readability measures the ease of understanding a text. Researchers studied Financial disclosures readability for years and assessed its impacts on various aspects of financial markets. Initial readability research work focused on comparative analysis. Readability scores vary between different sections of an annual report. Heath and Phelps (1984) analyzed 20 randomly selected Fortune 500 companies, 1981 annual reports, and nine business publications. They observed that financial disclosure sections were difficult to read. At the same time, they found that majority of business publications had similar readability scores.

Predominantly, annual reports and analyst's reports are the subjects of the prior research work. The firm's annual report provides comprehensive coverage of past achievements, enabling the readers to form, confirm, or revise future performance expectations. For this, the report's content must be readable and understandable. Report writers can improve information communication by being responsive to their audiences' reading and comprehension abilities (Courtis (1998)).

Readability measures

One of the frequently used measure for readability is the FOG Index. It is useful to differentiate school textbooks. It indicates the number of years of education needed to understand the text on a first reading. Thus, a Fog Index value of 16 implies that the reader needs 16 years of schooling- essentially a college degree-to comprehend the text on a first reading. It is a function of the average number of words in a sentence (length) and multi-syllable words percentage. Words with more than two syllables are challenging to comprehend.

$$\text{Fog Index} = 0.4(\text{average number of words per sentence} + \text{percentage of complex words})$$

One of the pioneering works that used the FOG index in disclosure analysis on a large sample was by Li (2008). In this widely cited paper, Li (2008) measured annual reports' readability using the Fog Index and researched the relation with the firm's subsequent performance. Numerous researchers have elaborated on this work and studied the association between readability and other firm attributes.

However, the FOG index's applicability, whose focus is on grade texts, has been questioned by other researchers. Using three different readability measures on a sample of 42,357 10-Ks during 1994-2007, Loughran and Mcdonald (2009) demonstrated that syllable counts for assessing readability might not suit business applications. They argue that of the Fog's two components, one is mis specified, and the other is difficult to measure. Further, Loughran and McDonald (2014) reported that file size of disclosure (10-K document) as a readability proxy outperforms the Fog Index. This measure's advantages include eliminating document parsing, replicability, and its correlation with other readability measures.

Readability drivers

While it is in analysts' and investors' interest to have readable disclosures, management's incentives might not be aligned with the same. Regulators took note of concerns about the complexity of firm disclosures and initiated efforts to improve annual reports' readability.

Regulators can influence the overall readability of disclosures with rules and guidelines. In October 1998, the SEC-mandated that firms use plain English in their prospectus and encouraged straightforward English usage in disclosures.

Based on textual analysis of Form 424, IPO prospectus, and 10-K filings over 1994-2009, Loughran and McDonald (2014), found that the SEC rule significantly impacted managers' disclosure style. They also found that firms with better corporate governance policies have higher compliance than others. Kubick and Lockhart (2016) demonstrated that SEC oversight influences disclosure practices and reduces the likelihood of stock price crashes. Similar responses to regulation are observed in other developed economies. Smith (2016) measured communication value using audit report readability and the tone. They found that after the passage of ISA 700 (U.K. and Ireland), audit reports are easier to read.

Li (2008) demonstrated that a firm's performance and readability of 10-K filings have a statistically significant relation. Using the Fog Index to measure readability, they find that loss-making firms use complex sentences in disclosures, supporting the theory of management obfuscation. Bloomfield (2008) tried to explain the drivers of length and readability of annual reports by conducting a longitudinal study of a single firm's 10-K's over three years.

Another critical factor that influences disclosure complexity and readability is the firm's business complexity itself. As business strategy fundamentally determines a firm's activities, it controls a firm's operating complexity, environmental uncertainty, and information asymmetry. Lim, Chalmers, and Hanlon (2018) investigated business strategy as a determinant of annual report readability. They found that firms pursuing an innovation-oriented prospector strategy have less readable 10-Ks relative to firms seeking an efficiency-oriented defender strategy. This finding suggests that a firm's strategy and operational complexity must be considered while interpreting readability.

The above literature attributes readability metrics to the reporting firms' operational complexity and obfuscation attempts. Contrary to this, Xu, Fernando, and Tam (2018) tried to explain the readability with the help of management age. Using upper echelons theory and business and social science research, they suggested that older CEOs and executives may be better at explaining operational complexities and staying ethical in reporting, thus leading to more readable financial reports.

conflicting findings no agreement

Readability vs firm features As the prior sub-section showed, readability has been used extensively in financial text analysis. The next subsection evaluates various firm attributes explained by readability measures in the literature. Firm profitability is one of the key measures that drive a firm's valuation. Analysts and investors are interested in explaining and forecasting variations in profitability measures and subsequent market returns. The initial focus of text analysis and readability of disclosures were on this topic. Li (2008) demonstrated that the readability of 10-K filings has a statistically significant impact on a firm's subsequent performance. They find that firms with losses, or with transient income, write annual reports with long sentences and big words. On the contrary, Lo, Ramos, and Rogo (2017) found a relationship between a firm's ability to beat the prior year's earnings and disclosure complexity. This reduction in readability with an increase in profits is contrary to Li (2008) findings and questions the assumption that good news is easier to communicate.

The participation of a large number of investors and specifically, small investors is essential for efficient markets. One measure that reflects this broad participation is trading liquidity. Investors' may find it challenging to understand and analyze complex disclosures and annual reports, which can reduce their willingness to trade, decreasing stock liquidity. Loughran and McDonald (2009) found a significant relation between improved 10-K readability and increased small investor trading as well as the likelihood of seasoned equity issuance. Studying market response to SEC EDGAR 10-K filings You and Zhang (2009), found that complex 10-K filings result in investors' under-reaction. Boubaker, Gounopoulos, and Rjiba (2019) examined the effect of annual report textual complexity on firms' stock liquidity and found that lower readability is related to more inferior stock liquidity. Their findings were robust to sensitivity tests, including endogeneity, alternative estimation techniques, and alternative liquidity and readability proxies.

If investors understand the annual reports, the stock price should respond to their information content. If investors cannot understand firm-specific information, the firm stock price may move broadly in line with the market. Stock return synchronicity, or co-movement, measures the extent to which the individual stock returns would comove with market returns. Improved readability in financial reports may reduce firm-specific information-processing costs and, therefore, minimize stock return synchronicity. Bai, Dong, and Hu (2019) investigated the relation between firm-specific information-processing cost, proxied by annual report readability, and investors' firm-specific information usage, proxied by firm stock return synchronicity. They found that annual reports' readability is negatively related to the firm's future stock return synchronicity. They note that this relation is more concentrated on firms with low analyst coverage or institutional ownership. As the impact is more focused in a specific type of firms- small firms, firms with high R&D spending, or high growth firms, they relate it to information asymmetry

Another side of information asymmetry is management information hoarding. Managements may not be willing to share the information adequately for various reasons. Firms with less readable annual reports suffer from less transparent information disclosure and may bear the increased cost of external capital as lenders might charge a premium due to uncertainty. In their investigation of the relation between a firm's annual report readability and borrowing costs,

theoretical backup for feature selections 12

AR → story-telling / marketing

Investor Day → outreach to key investors (institution)

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so get their buy-ins / educating / communication / Signaling

Ertugrul et al. (2016), firms with lower readability scores and higher uncertain tone in 10-Ks have stricter loan contract terms and greater future stock price crash risk. Another significant aspect of a firm's behavior that investors and analysts are worried about is the possibility of on-going fraud. Obfuscation and deception theories from accounting and communication literature suggest that management producing 10-Ks can deceive by hiding harmful news in complex and unreadable content while highlighting achievements. Moffitt and Burns (2009) examined 202 fraudulent and non-fraudulent 10-Ks by focusing on 25 linguistic cues. The results indicate that fraudulent 10-Ks have more complex words, signaling words of achievement and cause, and qualifying conjunctions. They also noted that truthful 10-Ks have better FRE readability and use more present tense verbs. Others have studied firms indulging in Foreign Corrupt Practices. Lopatta, Jaeschke, and Yi (2014) tried to detect a firm's likelihood of violating the FCPA using disclosure tone and readability. Management of FCPA violators tends to use negative, uncertain, litigious, and complex language than non-violators. They also noted that managers strategically adjust tone in 10-K filings after FCPA prosecution. One consequence of fraud is that investors can take legal recourse if they incur a financial loss due to the misleading information shared by management in financial disclosures. So, the text content and narrative disclosures can influence subsequent shareholder litigation. Based on federal securities class action lawsuits over two decades, propensity-score matched samples, and linguistic measures (readability and sentiments) in textual disclosures, Ganguly (2017), found poor readability in disclosure is often perceived as misleading after the fact and results in litigations.

Other researchers have explored the importance of numbers in understanding financial disclosures and questioned their exclusion in prevalent textual analysis research. Siano and Wysocki (2018) showed that the prevalence of numbers in annual reports is positively correlated with the disclosure's readability. They also demonstrate that prior findings on the links between disclosure readability and firm performance can be explained by the ubiquity of numbers in the disclosures. These studies limit, if not undermine, the applicability of readability research.

Analyst reaction

Prior research focused on investors and analysts as investment decision-makers and how they use disclosures. Managers use some of the disclosure content to influence analysts as facilitators. As analysts act as intermediaries between management and final investors, the analyst needs to comprehend management's signal. Also, as analysts track specific industries, industrial jargon in disclosure would not deter them and will not hinder their ability to understand disclosures. In recent years, academic research in this domain has picked up. Based on 10-k readability, Lehavy, Li, and Merkley (2011) documented that less readable reports require analysts to spend more effort to generate reports. They find that less readable 10-Ks are associated with higher uncertainty in analyst earnings forecasts. Their findings are in line with the expectation that more analyst services are required for evaluating firms with lesser readability content in disclosures.

Readability reduces the agency costs and information asymmetry between investors, attracting more financial analysts to track a firm. Diaz, Njoroge, and Shane (2017) suggests that increased uncertainty created by greater complexity, opacity, and volume of information in 10-K filings causes analysts to react with more restraint compared to the time of earnings announcements. Sourour, Badreddine, and Aymen (2018), using the Gunning Fog index and the Flesh Reading Ease formula, investigated 88 companies listed on the French CAC All between 2009 and 2014. They concluded that number of analysts following a firm, and as a result, the attention paid by institutional investors is directly related to the readability of the financial disclosures. The recommended using short sentences, familiar words, or the active voice in disclosures reduces the cognitive distance between management and investors.

Other researchers have studied the relation between analysts' reports readability and stock price performance as it may affect value-relevant information. Hsieh and Hui (2013) found that analyst report readability reduces forecast dispersion, and that market reaction is significantly positive towards more readable reports. Hsieh, Hui, and Zhang (2016) further finds that this effect is significantly positive only for firms with information asymmetry, i.e., higher R&D spending, higher bid-ask spreads, and a greater proportion of uninformed investors, and more experienced analysts. These empirical findings indicate that analysts' reports reduce future earnings uncertainty, and investors incorporate it into the market price.

This sub-chapter has surveyed how researchers have conducted financial text analysis. The next section will review various organizational outcomes that researchers have tried to explain using disclosure text content.

4 Firm-Specific attributes and events analysis

This sub-chapter explores firm attributes that researchers have studied using disclosure content. A public firm is an ongoing concern and goes through different stages in its life cycle. Firms respond to and influence the drivers in the ecosystem through planned and reactive measures. This behavior results in measurable changes in firm attributes. Investors are interested in target company attributes like business strategy, exposure to risk, senior management performance, fraudulent reporting, competition, profitability, and financial distress. Researchers have found evidence

linking many firm attributes and the language used in disclosures. One of the foremost attributes of a firm is its business strategy. As business strategy fundamentally determines a firm's product and market domain, technology, and organizational structure, it influences a firm's operating complexity, environmental uncertainty, and information asymmetry. Consequently, the business strategy frames the level, wording, and complexity of disclosures. Lim, Chalmers, and Hanlon (2018) investigated the influence of business strategy on annual report readability. They measured 10-K readability with Li's (2008) Fog index. They found that firms pursuing an innovation-oriented prospector strategy have less readable 10-Ks relative to firms seeking an efficiency-oriented defender strategy. They also found that prospectors display more negative and uncertain tones while defenders exhibit a more litigious tone in their 10-Ks. Fengli, Lundholm, and Michael (2013) observed limited and indirect evidence that management strategically makes misleading statements about their competitive landscape. Bushman, Hendricks, and Williams (2014) used textual analysis to extract a bank-specific competition measure to examine the relationship between competition and bank stability. CEO characteristics influence a firm's performance and disclosure narratives. Hendricks, Lang, and Merkley (2017) examined whether firms' regulatory filings' textual attributes reflect CEO characteristics and whether investors consider this relation when assessing firm value. They found that 10-K text for founder-led firms has "excess" optimism relative to current and future realized earnings and compared to non-founder-led firms. They provided broad sample evidence that CEO fixed effects are significantly related to several textual attributes. Subsequently, Buchholz et al. (2018) examined the driver behind this excessive over-optimism and linked it to CEO narcissism.

4.0.1 Ethics & trust

With the increased importance of corporates role in society, stakeholders expect firms to conduct their business in an ethical and trustworthy manner. It is challenging to measure Ethical behavior using traditional financial metrics. Trust is ethically important and essential for business. It is not easy to measure whether a firm has a trusting corporate culture. Audi, Loughran, and McDonald (2016) developed an objective measure of trust in a firm's corporate culture by counting the frequency of 21 trust-related words in MDA. They concluded that firms with a trusting culture frequently use audit and control-type words and that trust explains subsequent share price volatility. Loughran and McDonald (2016) examined the occurrence of ethics-related terms in 10-K annual reports. They observed that ethics-related terms are frequently used by "sin" stocks. These firms have poor corporate governance and are likely to be the target of lawsuits.

4.1 Financial distress

Investors are keen on knowing about the health of the firms they may invest in the future. A firm in financial distress loses a significant amount of its shareholder's value. If the management cannot tide over the crisis, the firm may have to file for bankruptcy, resulting in a 50% to 80% loss of capital for shareholders and lenders. Financial distress and bankruptcy prediction is an actively researched field. Researchers attempted to incorporate text features into such predictive models. Below is a brief review of the same. Auditors express going-concern opinions based on the firm's obligations and liquidity. Financial disclosures include these opinions. Change in such disclosures can act as a signal to identify distress. However, auditors do respond to external financial markets. Beams and Yan (2015) examined the financial crisis's effect on auditor going-concern opinions and concluded that the financial crisis led to increased auditor conservatism. A going-concern opinion in disclosures is associated with the number of forward-looking disclosures and their ambiguity. Enev (2017) observed that while the absolute number of forward-looking disclosures is lower for companies receiving a going concern opinion, the proportion of forward-looking disclosures in the MDA is higher in the presence of a going concern opinion. The results suggest generally improved forward-looking disclosures in MDA when companies receive a going concern opinion from their auditor. One consequence of distress is financial constraints. Firms undergo reduced cash flows during stress, which results in liquidity events - like dividend omissions or increases, equity recycling, and underfunded pensions. Analysts measure the extent of financial constraints to assess the capital structure. Bodnaruk, Loughran, and McDonald (2013) used constraining-words based lexicon to measure the same. These measures have a low correlation with traditional financial constraints measures and predict subsequent liquidity events better. Ball, Hoberg, and Maksimovic (2012) used text in firms' 10-Ks to measure investment delays due to financial constraints. They found that the fundamental limitations are the financing of R&D expenditures rather than capital expenditures and that the main challenge for firms is raising equity capital to fund growth opportunities. These text-based measures predict investment cuts following the financial crisis better than other indices of financial constraints used in the literature.

4.2 Bankruptcy

Once a company is unable to come out of distress, it will become insolvent. Insolvency is the state in which the company is not capable of honoring some commitment. Lenders and claim holders can force the insolvent company to discontinue operations. Managements file for bankruptcy protection to recover from such a situation or liquidate it in

an orderly manner. Bankruptcy prediction has been an active research topic for accounting researchers over decades. Most prior bankruptcy prediction models were developed by using financial ratios. However, signs of distress may appear in the nonfinancial information earlier than changes in the financial ratios. Current distress measures tend to miss extreme events, especially in the banking sector (Gandhi, Loughran, and McDonald (2017)). In recent years, qualitative information and text analysis have become necessary because frequent changes in accounting standards have made it difficult to compare financial numbers between years (Shirata et al. (2011)). The language used by future bankrupt companies differs from non-bankrupt companies. Hájek and Olej (2015) studied various word categories from corporate annual reports and showed that the language used by bankrupt companies shows stronger tenacity, accomplishment, familiarity, present concern, exclusion, and denial. Bankrupt companies also use more modal, positive, uncertain, and negative language. They built prediction models combining both financial indicators and word categorizations as input variables. This differential language usage is observed in non-English firms' disclosures also. Shirata et al. (2011) analyzed the sentences in Japanese financial reports to predict bankruptcy. Their research revealed that co-occurrence of words "dividend" or "retained earnings" in a section distinguish between bankrupt companies and non-bankrupt companies.

Working on U.S. Banks Gandhi, Loughran, and McDonald (2017) used disclosure text sentiment as a proxy for bank distress. They found that the annual report's more negative sentiment is associated with larger delisting probabilities, lower odds of paying subsequent dividends, higher subsequent loan loss provisions, and lower future return on assets. Similarly, Lopatta, Gloger, and Jaeschke (2017) concluded that firms at risk of bankruptcy use significantly more negative words in their 10-K filings than comparable vital companies. This relationship holds up until three years before the actual bankruptcy filing. Other notable works using text analysis for bankruptcy prediction were Yang, Dolar, and Mo (2018) and Mayew, Sethuraman, and Venkatachalam (2015). Yang, Dolar, and Mo (2018) used high-frequency words from MDA and compared the differences between bankrupt and non-bankrupt companies. Mayew, Sethuraman, and Venkatachalam (2015) also analyzed MDA with a focus on going-concern options. They found that both management's opinion about going concern reported in the MDA and the MDA's linguistic tone together provide significant explanatory power in predicting whether a firm will cease as a going concern. Also, the predictive ability of disclosure is incremental to financial ratios, market-based variables, even the auditor's going concern opinion and extends to three years before the bankruptcy.

This sub-chapter reviewed the firm attributes that researchers tried to explain using disclosure narratives. The majority of the work focused on explaining risk exposure, fraud, financial distress, and bankruptcy. Of these, default is a significant event in a firm's life and significantly impacts stakeholders. Hence this research focuses on the bankruptcy prediction task. The next sub-chapter will review the models used by analysts for text analysis.

5 Modeling approaches used

sentiment, tone, readability

The previous sections reviewed text analysis in finance in terms of the content analyzed, linguistic features extracted from the text, and firm attributes explained with those features. This section outlines the statistical methodologies and models used in the text analysis of financial disclosures. There are two dimensions to the models in Text analysis in finance. First deals with the language model—the other deals with underlying economic or financial process modeling.

5.1 Language models

fin. distress / bankruptcy

As natural language is messy, researchers convert information from texts into quantifiable variables and then use them in subsequent modeling efforts. Language models make assumptions about how information is encoded in language and translate it into a usable form. There are broadly two categories of language models Dictionary-based and statistical models. While they try to capture information in a language differently, these models are complementary (Matthies and Coners (2015))

good explanation !!!

In dictionary-based models, the text under consideration is split into words, and the words are categorized based on dictionaries. One can consider a document in terms of raw word frequencies in it. This method would result in a large number of dimensions, as every word in the dictionary has representation. Context or domain-specific dictionaries are useful in reducing the dimensionality compared to raw word frequencies. Some of the dictionaries used are Diction, General Inquirer, and the Linguistic Inquiry and Word Count (F. Li (2010b)), Harvard and Loughran. Loughran built their dictionary explicitly for text analysis in finance. Li (2006) measured risk-sentiment of 10-k disclosures using risk or uncertainty related word frequency.

limitations

Dictionary-based models suffer from the shortcomings of all Bag of Words approaches. These models consider words as the critical information block and ignore the order of words. Also, any misclassification in the dictionary will lead to erroneous results Loughran and McDonald (2009), Loughran and McDonald (2009), Loughran and McDonald

(2014), discuss how usage of generic dictionaries leads to large scale miss-classification of words. Also, Van Den Bogaerd and Aerts (2011) noted that while most of the text classification work in the accounting industry and research is done manually, an erroneous, expensive process, few research papers mention the accuracy of the used classification methodology.

Another challenge with raw word frequency is frequently occurring words, which might not have essential information. Alternatively, one can use novelty-based weights. Term frequency- Inverse Document Frequency (TF-IDF) gives higher weights to frequent terms that are infrequent across the documents. Smailović et al. (2018) conducted a differential content analysis based on TF-IDF weighting and evaluated correlation with financial variables. They considered linguistic features such as personal/impersonal pronouns ratio, sentiment, trust, doubt, certainty, and modality. Qiu (2007) constructed TF-IDF from financial statements and built SVM-based classifiers to predict future company performance.

In recent years, continuous or vector representation of words has dramatically improved NLP tasks performance in other domains. Some of the earlier approaches include latent representations like Latent Semantic Analysis (LSA) and Latent Dirichlet Analysis (LDA). Later methods include Word2Vec, Global Vectors (GloVe), Contextual word vectors (CoVe), and Elmo. These were predominantly encoder driven architectures. In the past two years transformer driven language representations have resulted in state-of-the-art performance on numerous NLP tasks. Some of them are Bidirectional Encoder Representations from Transformers (BERT), Generative Pre-Training (GPT1, and GPT2). While researchers used probabilistic distribution language models like LDA in prior research (Chen et al. (2018)), they are yet to use other advanced language models.

5.2 Process models

Research in Financial text analysis is motivated by the need to understand firms' disclosure information and investors' sentiments about firms. The availability of public disclosures shapes much of the research work in the domain. As most of the studies were correlational, analysts constructed various regression models based on their objective. While previous years have seen the dominance of hand-crafted variables from the text in financial disclosures, representative learning, and deep learning models have emerged as an alternative in the past 24 months.

5.2.1 Regression models

Regression models are useful in analyzing variables in finance and accounting. Researchers extended the same approach to incorporate text information. The text features could be raw word frequencies, derived features based on dictionaries, or outputs of prediction and ranking models that transform some firm attributes into numeric form. Foster and Hussey (2006) studied corporate transformation and its success factors in large U.S. listed firms. Selecting firms with a deteriorating performance that may need strategic shifts, they built a prediction model to identify formalized transformation programs based on restructuring costs and significant corporate announcements. They extracted the firm's strategic intent from annual reports MDA and converted it to a numerical value. Using these features, they constructed a regression model to explain the relationship between the number of factors on change in total shareholder return (TSR) during transformations. Bochkay (2014) used the "bag-of-words" (BOW) approach to represent MD&A sections and regularized regression methods to handle high-dimensionality and multicollinearity. Others conducted correlation studies predominantly to understand the relations between linguistic features and financial aspects Smailović et al. (2018).

5.2.2 Bayesian models

One of the preferred statistical modeling approaches is Naive Bayesian machine learning. F. Li (2010b) assessed the information content of the forward-looking statements (FLS) in MDA of 10-K and 10-Q filings using a Naive Bayesian machine learning algorithm. Brown, Crowley, and Elliott (2016) used a Bayesian topic modeling algorithm to quantify the topic content of annual reports and assessed if it is incrementally informative in predicting intentional misreporting. Humphreys et al. used Naive Bayes and decision trees on public disclosures for deception detection. For text sequence modeling, conditional Random Fields (CRF), a discrete classifier model, has been used. Chen et al. (2011), chen (2013), extracted opinionated statements from MDA of 10-K, using CRF based tagging models. They considered multiple combinations of linguistic factors such as predicate-argument structure, morphology, syntax, orthography, and simple semantics.

5.2.3 Comparative analysis

While individual approaches have their merits, comparative analysis in the given context can throw light on models' strengths. Chen et al. (2018) used topic modeling and evaluated multiple topic modeling approaches and their

effectiveness. They applied four primary topic modeling methods - Principal Component Analysis, Non-negative Matrix Factorization, Latent Dirichlet Allocation, and KATE, to analyze SEC filings by U.S. public banks. Others have used ranking, clustering, or SVM models to explain the processes. Tsai and Wang (2013), Qian and Li (2013), attempted to use text in disclosures to rank the risk levels of a set of companies. Glancy and Yadav analyzed MDAs in 10-K filings for deceptive statements, using expectation maximization and hierarchical clustering. Qiu (2007) built SVM based classifiers to predict future company performance based on linguistic features.

5.3 Deep learning

Over the years, in classification tasks, logistic regression models have outperformed other fraud detection models and other problems of quantitative financial analysis (Beams and Yan (2015), Bose, Piramuthu, and Shaw (2011), LeWitt (1988), Zhang (2016), Mousa Albashrawi (2016), Bao et al. (2015)). In his evaluation of Machine Learning models for Fraud detection, Zhang (2016) compares five state-of-the-art classifiers, i.e., logistic regression, artificial neural network, support vector machines, decision trees, and bagging, and concludes that bagging performs the best. The non-linear nature of the underlying process can explain this outperformance. Hence, neural network models, which are viewed as a series of logits, can excel in these tasks. The advantages of the neural network models have motivated some researchers to use them in text analysis in finance. In a review of various text analysis methods, Guo, Shi, and Tu (2017), note that neural network outperforms other machine learning methods in news category classification.

Qualitative information in corporate annual reports is more abundant than what the previous models have been able to capture and leverage. When measured actively, many of the linguistic features are informative (Azimi and Agrawal (2018)). With improved hardware performance and better algorithms, multi-layer neural networks have become economical to train in recent years. This method, also known as deep learning, has resulted in state-of-the-art performance in many NLP tasks. Encouraged by the trend, some researchers have tried to use deep learning in text analysis of finance. Tao, Deokar, and Deshmukh (2018a) used deep learning methods to predict pre-IPO price revisions and post-IPO first-day returns using forward-looking statements (FLSs).

While traditional regression models yield good results while using limited hardware, the out of sample results are not satisfactory. The advent of deep learning methods led to researchers exploring them in the text analysis of disclosures. Azimi and Agrawal (2018) used deep learning to measure and classify sentiment in SEC 10-K filings and achieved 90% accuracy in out-of-sample tests. These sentiment indicators have a better predictive power of future stock performance. Similarly, Song (2017) extracted textual features from Item 1 Business descriptions in 10-K, using a deep learning algorithm to incorporate word contexts. Rawte, Gupta, and Zaki (2018b) used deep learning and Support Vector Machines (SVM) for bank failure classification using textual analysis. Using changes in the 1A sections, they built models to predict the risk indicators like leverage and Return On Assets (ROA). The above findings indicate that while deep learning methods help extract more information or signal from narrative disclosures, they are yet to be used extensively in text analysis of finance.

6 Conclusion

Prior sections lay out the need for better tools to extract knowledge from the financial disclosure test. Research in financial text analysis used disclosure text metrics such as readability and sentiment to explain attributes like risk exposure and financial distress. These works used text features along with traditional accounting metrics. These metrics, while having meaningful signals, discard most of the information in the disclosure text. Hence the marginal gain in the knowledge from such partial text analysis may not justify the efforts required for undertaking financial text analysis.

Narrative content in financial disclosures has critical information required to understand the organization state, predicting future organizational outcomes. Extracting this information and identifying the relationship between such information and organizational outcomes is also critical for investors' ability to use the same.

This work has surveyed the literature on text analysis in finance, explored frequently applied methods, and delineated the components that have been the focus of studies. The following salient points emerge from this survey of the prior work:

- 1) Text analysis in finance is still in the early stages, focusing on broad information extraction indicators, like readability, FOG index, and sentiment analysis.
- 2) Readability-driven text analysis may not be suitable for measuring the effectiveness of business communication. Loughran and McDonald (2014) showed that financial jargon and information integration are correlated.
- 3) Generic dictionary-based methods suffer from misclassification issues.
- 4) Many research questions can be answered with proper text analysis of financial disclosure documents

binary 0/1
category 1/2/3/4/5
score 0~10

vector [...] $\in \mathbb{R}^n$

graph ??? to store states



- Firms' financial health, stress, and future bankruptcy can be assessed from ongoing concern comments.
 - Fraud and misreporting can be assessed from management disclosures and notes to accounts.
 - Companies future litigation risk, operational risk, and other risks can be assessed from risk disclosures.
 - Firm's business strategy, competitive position, and strategy changes can be captured from product and business descriptions.
- 5) Efficient extraction of information from the text can enhance narrative texts' forecasting power about firm attributes.
- 6) Machine learning methods and neural representation learning methods can be useful in financial text analytics.

6.1 Future research

Investors need computational methods to extract knowledge from disclosure texts that can explain firm attributes. Researchers need to examine the information contained in the financial disclosures text and its relationship to organizational outcomes.

The research question can be framed as below.

- Given a firm's financial disclosure, what can we infer about its current state?
- Which of the possible organizational outcomes can we predict?

From a methodology perspective, the research question can be framed as follows. Given a prior labeled dataset of firm outcomes and relevant period disclosure documents,

- Which of the textual features of the disclosure are relevant for analysis?
- Can we infer relations between text features and organizational outcomes?
- Can we build predictive models?

The following research work is required to answer the above questions.

- Conduct quantitative correlation studies to identify relations between different linguistic attributes and organizational outcomes.
- Considering the information in text disclosures, exclusively text-based analysis methods can be feasible and valuable in financial and accounting analysis. Build predictive and classification models purely based on linguistic disclosure features.
- Domain-specific dictionary methods can overcome generic dictionary methods in text analysis. Build multi-task and task-specific dictionary models and evaluate their predictive and explanatory power.
- Modern representation learning techniques and affordable hardware and open source tools allow large scale machine learning. These tools help in overcoming the limitations of "bag of words" approaches. Build representative language models for financial disclosure text analysis and evaluate their performance.

→ Conclusion is abt weak...

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