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An analysis of ERP annual report disclosures

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Abstract

Investments in enterprise resource planning systems (ERP) are increasingly significant and critical to the success of the firm. Prior research finds capital markets value information about firms' investments in technology. This study develops a sample of firms with and without disclosures about ERP in their annual report to examine disclosure choice. Results indicate that firms often choose not to disclose ERP in their annual report and that the choice to disclose is significantly associated with capital market transactions, firm performance, firm size and industry. For those firms choosing to disclose, the study also reports a descriptive analysis of the disclosures and summarizes significant diversity of disclosure practice along the primary dimensions of costs, goals and risks. Given the conceptual foundation of accounting, that comparability between firms increases the informational value of disclosure, the study's findings suggest a need to develop additional standards to enhance the value of annual report disclosures about technology.

Keywords: ERP; Voluntary disclosure

1. Introduction

This study examines firms with annual report disclosures related to enterprise resource planning systems (ERP) and compares these firms to firms that choose not to disclose ERP

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information in their annual reports. Current regulatory standards are unclear and incomplete regarding disclosure of investments in ERP in annual reports such that significant variations in practice are possible. Variation in disclosure practice can cause annual reports to be less informative.

According to the Financial Accounting Standards Board (FASB), informative disclosures help investors and creditors understand the company better thereby making the capital allocation process more efficient (FASB, 2001). Prior research supports this premise by documenting that extensive voluntary disclosure is generally associated with improved stock liquidity, reduction in the cost of capital, and increased following by financial analysts (Healy and Palepu, 2001). FASB Concepts Statement No. 2 establishes the importance of comparability and consistency and the role each plays in producing high quality, valued accounting information (FASB, 1980). A primary means of achieving comparability and consistency is through disclosure of items in the annual report.

Disclosure of financial issues and activities surrounding ERP implementation should be important to users of financial statements. Prior research finds that the capital markets reward firms for adopting ERP with higher market valuation and suggests that disclosures about ERP implementations are informative (Hitt et al., 2002; Hayes et al., 2001). Further, the American Institute of Certified Public Accountants' (AICPA) report on improving business reporting (Jenkins' report) suggests that users need information about a firm's activities, processes, and events (AICPA, 1994). ERP implementations are increasingly prevalent (Hitt et al., 2002) and often represent the firm's largest single investment in information technology (IT) (Sumner, 2000). ERP systems can directly affect many of the primary activities and processes in a firm and ERP implementation is generally a major event (Poston and Grabski, 2001). In particular, the Jenkins' report recommends disclosure of costs of key resources and forward-looking information about opportunities and risks (AICPA, 1994). ERP systems provide opportunity to dramatically change and improve operations in a firm but also introduce significant risk (Hitt et al., 2002). Based on the Jenkins' report, we suggest investors need information about ERP implementations and that companies should disclose information about the costs, goals (opportunities) and risks of ERP.

The extent to which disclosures improve the capital allocation process depends on their credibility because management has incentives to distort or not fully reveal information (Healy and Palepu, 2001). Given the voluntary nature of ERP disclosures, it is likely that disclosure practice varies considerably. Therefore, we first analyze the disclosure choice by examining the determinants of the decision to disclose ERP in the annual report. We then examine the comparability and consistency of ERP annual report disclosures across firms choosing to disclose.

Specifically, we searched all US Securities and Exchange Commission (SEC) annual report filings from 1998 to 2001 and identified 453 firms with ERP-related annual report disclosures. Additionally, we searched Lexis-Nexis press releases for the same time period and identified 134 publicly traded firms with an ERP implementation but without ERP-related annual report disclosures. Finally, we also obtained partial client lists from two major ERP vendors and identified 102 additional publicly traded firms implementing ERP in the same time period without related annual report disclosures.