Abusive Earnings Management and Annual Report Readability

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Abstract

This study examines the association between abusive earnings management and annual report readability. The sample of this study consisted of 200 manufacturing companies listed on the Indonesia Stock Exchange. Using the Fog Index to measure readability, the results of the study indicate that abusive earnings management has an effect on annual report readability. The results showed that abusive earnings management affected the annual report readability.

Keywords: abusive earnings management, annual report readability, external auditors, internal control

Introduction

The readability of financial statements becomes an interesting conversation in the capital market. Companies that do abusive earnings management cause bad annual report readability. Li, (2008) said that companies with poor readability have an impact on the persistence of bad earnings. Several studies have shown that the readability of financial statements is related to earnings management (Lo et al., 2017), serious problems in the capital market (Luo, Li, & Chen, 2018). However, research in Indonesia on annual report readability is still limited. Abusive earnings management worsens annual report readability.

This research investigates Abusive Earnings Management on annual report readability. Hassan et al., (2019) found a positive relationship between annual reports that are easy to read and company profitability. Lo et al., (2017) found that companies with poor readability were associated with serious earnings management problems.

Previous studies calculated readability by using the number of pages, sentences and characters in a company's annual report, because there is no proxy generally accepted in measuring the readability of the Chinese annual report. While this study uses the Gunning Fox Index to measure the level of readability of the company's annual report. This study uses manufacturing companies as research objects because the company is the largest industry in Indonesia so that it can represent all companies in Indonesia (Krisnauli & Hadiprajitno, 2014).

This research is expected to be used to optimally disclose textual information contained in annual reports and by using language that is easily understood by all users of annual reports. This research is expected to provide information to stakeholders in assessing and analyzing information contained in annual reports, so it can be the basis for decision making. The purpose of this study was to examine whether abusive earnings management to annual report readability.

Relevance and reliability are characteristic determining quality of accounting information. reliability is information that free from errors and bias; hence, it can be used by the users of accounting information to make a decision. Meanwhile, Information is relevant when it has content that make the users of accounting information change their mind (Tseng, 2013). Perspective of value relevance can be interpreted by four approaches, i.e. perspective of fundamental analysis, measurement, information, and prediction. First, perspective of fundamental analysis means that value relevance emphasising on usefulness of accounting information for valuation of equities. In this perspective, the value relevance is assessed by return obtained when trading strategy is relied on the accounting information solely. It means that the accounting information is relevant

when it can be used to predict earnings, dividend and future cash flow. As the accounting information is reflected in stock price. In case of earning management, earnings measurement need to be adjusted in order to minimise effect of the manipulated earnings. The second perspective perceive that investors do not use the accounting information for assessment because the investors got another information faster than accounting information (Felix & Rebecca, 2015).

Sometimes there is a trade-off between those characteristics. For example, recognition of expenditure for R&D as expense in current period instead of as an asset will affect reported earning in financial statements (Tseng, 2013). Furthermore, relevance and reliability are closely related with persistence of earning indicating current earning will occur in the following period. If capital market obtained information about unexpected earnings and the market considers that it has high persistence and it can be used to evaluate performance of company in the future; then the stock price will experience major correction (Tseng, 2013). Therefore, earning persistence is very relevant in this study because in this study observes every single earning components and how the components is communicated to the users of information.

Earning management can be defined as choosing accounting method based on generally accepted accounting principle that favourable for management. *"Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company, or to influence contractual outcomes that depend on reported accounting numbers"* (Healy and Walen, 1999).

Earning can be managed to increase or decrease based on expected incentive. Earning management occur because of flexibility of accrual accounting that enable manager to use their knowledge about accounting principle to improve usefulness of financial statement. Usually, manager has internal and external motives that encourage them to use their judgement resulting bad practice of earning management. Consequently, the practice will be decreasing quality of financial statement because the financial statement only reflects interest of management instead of performance of firms (Thi, 2015)(Rahman, Moniruzzaman, & Sharif, 2013).

The most common techniques employed in earning management is managed the earning to increase. The practice can be applied by several methods, first, decreasing expenses. Discretionary expenses that usually deducted are R&D, advertising, and maintenance. Cutting the expenses will affect in long term because it will impair competitive advantage of the company. Secondly, sales manipulation in order to achieve sales target by offer big discount or credit. This practice also emphasis on short term. Third, increasing production scale in order to decrease cost of goods sold, which is very risky in the future as this practice will cause excessive stock (Thi, 2015) (Omar et al., 2014).

Referring to *Statement of Auditing Standards* (SAS) No.99 issued by *Auditing Standard Board* (ASB) on November 2002 define fraud in financial statements as *"intentional misstatements or omission of amounts of disclosures in the financial statements designed to deceive financial statement users"*. Based on the above definition, fraud in financial statement is misconduct of accounting standard intentionally to deceive users of financial statements (Omar et al., 2014).

According, study of Perols and Lougee (2011) indicated that possibility of fraud tend to higher in company that previously do earning management than company that never do earning management before. Usually, it is triggered by agency conflict to maximise compensation to management, which stimulate management to do fraud and put on shareholders' expense.

In 1999, SEC focused on financial statements issues that is known as *"abusive earning management"* particularly in public companies. The abusive earning management applied several methods in order to 'improve' financial performance. As an attempt to minimise the practices, SEC issued Staff Accounting Bulletin

No. 99 focusing on materiality of financial statements, and following bulletins emphasise on liabilities restructuration and assets impairment along with several conditions needed for revenue recognition (SEC, 2001).

Accounting is regarded as language of business enabling management to communicate with shareholders. Hence, accounting and linguistic have numbers of commonalities. Even Jain (1973) cited from Belkaoui (1978) analogous accounting standards as financial grammar. Referring to the analogy, grammatical structure will affect 'listener' or decision maker. As language, accounting has lexical and grammatical characteristics, which affect 'listeners' conception.

Study of language focuses on four areas, i.e. structural linguistics, developmental psycholingustics, linguistics relativity and sociolinguistics. First, structural linguistics is a process of acquisition of language and identification of formal structure. Second, psycholinguistics emphasises on formulating language and use it in cognitive function. The third area is related role of language in conception of the world in which speaker of one language is different with speakers of another language.

Fourth, sociolingustics deals with different linguistics code associated with different social strata affecting social behaviours (Belkauoui, 1978). Measuring and testing linguistics dimension is regarded as unusual approach to study language and deception. In this world contains various linguistics cues, but previous studies indicated the predictive power of individual linguistics cues (Newman et. al., 2003).

Methods

The sample of this study consisted of 200 manufacturing companies listed on the Indonesia Stock Exchange in the 2014-2017 period. To test the hypothesis using regression analysis as follows:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where:

Y	=	annual report readability
α	=	Constanta
β_1- β_3	=	Coeficien
X_1	=	Abusive Earnings Management
X_2	=	Internal control (Control Variable)
3	=	Exsternal auditor (Control Variabel)
E	=	*Error*

Readability

As conducted by (Rennekamp, 2012; Loughran and McDonald, (2016) and Lo et al., (2017) in this study, researchers will measure the readability of company reporting using the Gunning Fox Index. Formula to measure the readability of company reports as follows:

$$Fog = 0.4 \times (word\ per\ sentence + Percent\ of\ complex\ word)$$

The number of words per sentence is calculated as the ratio of the total number of words divided by the number of English sentences in the management of the company's annual discussion & analysis report. Complex words are words that have three or more syllables. The higher the readability score of the Gunning Fog Index, the more difficult the text to read is understood. The lower the readability score of the Gunning Fog Index, the easier it is for a text reader to understand.

Abusive Earnings management

Abusive Earnings management measurement uses the aggressiveness of real earnings management which refers to the research of Roychowdhury (2006). Measurement of the aggressiveness of the three real earnings management activities in Roychowdhury (2006) research, namely abnormal sales (Pj_Ab), abnormal production (Prod_Ab), and abnormal discretionary costs (BD_Ab). Abusive Earnings management in this research uses abnormal discretionary costs with the following calculation:

Abnormal Discretionary Costs (BD_Ab)

$$BD\_Ab_{j,t} = \frac{BD_{j,t}}{A_{j,t-1}} - \frac{BD\_N_{j,t}}{A_{j,t-1}}$$

Where:

$BD\_Ab_{j,t}$ = Company Abnormal Discretionary Cost j in t

$BD_{j,t}$ = The real discretionary costs of company j in year t as measured by research and development costs + advertising costs + sales, general and administrative costs

$BD\_N_{j,t}$ = Normal company Discretionary Cost j in year t as measured by the equation.

$A_{j,t-1}$ = Company assets j in year t-1

Control variables

External Audit

In this study the quality of external audits is measured by the presence of large-scale and reputable public accounting firms affiliated with Big Four Worldwide accounting firms. So that the quality of external audits is calculated as has been done by Gerayli et al, (2011), namely by using a dummy variable by giving a value of 1 if the audit report is carried out by a public accounting firm, and a value of 0 if the audit report is not carried out by the public accounting firm The Big Four .

Internal control

researchers used content analysis to calculate the internal control index (Leng and Ding, 2011). Then the analysis is based on whether items / phrases are used (available) or not used (none) in the annual report that refers to internal control information (Uyar and Kilic, 2012). Total internal control disclosure items are a maximum of eight items per company. So that it can be formulated as follows:

$$\text{Index Pengendalian Internal} = \frac{\sum \text{Actual Disclosure}}{\text{Possible disclosures (8 items)}}$$

$$= \frac{\sum_1^m di}{\sum_1^n di} \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots(3.3)$$

Where :

d_i = is worth 1 item if disclosed (value 0 if not disclosed)

m = the number of items disclosed

n = the maximum number of items that might be disclosed

Table 1.Internal Control Evaluation

Items	Content
Control Environment	Governance structure, human resource policies, corporate culture.
Risk Evaluation	Internal and external risk identification, risk analysis, risk response.
Control Activity	Internal control activities based on risk.
Information and communication	Establishment of information and communication systems.
Internal monitoring	Internal oversight of the internal audit department.
Internal Damage Control	Damage to abnormal items in internal control and its repair methods.
Internal Assessment	Assessment of the board of directors.
External Assessment	Rating of external auditors.

Source : Leng dan Ding (2011)

Results

Table 2. Test result

		Coefficients[a]				
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	T	Sig.
1	(Constant)	15.967	.593		26.905	.000
	EM_Riil_Diskresioner	.261	.155	.117	1.676	.095
	Pengendalian_Internal	1.976	.737	.187	2.679	.008
	Audit_Eksternal	-.043	.265	-.011	-.160	.873
a. Dependent Variable: Readability						

The test results show that abusive earnings management measured by real desig- nary management earnings evaluates the annual report readability. The results of this study are in line with Li, (2008), Perols & Lougee (2011), Lo et al. (2017), Hassan et al., (2019). The result of evidence of State that fraud has the same object as earnings management but differs in terms of earnings management in that fraud is outside of generally accepted accounting principles. Abusive Earnings Management has an impact on annual report readability. That a company that has poor legibility relates to serious earnings management issues.

Conclusions
1. Abusive earnings management affects the annual report readability.
2. Internal control is proven to be an Abusive earnings management control in explaining annual report readability, whereas external audit is not proven to be a control variable.

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