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Earnings Management and Annual Report Readability

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ABSTRACT

The annual report is just one of the ways that managers could have relationship with investors. Managers have many limitations in communicating with investors, so Annual Report is a legible way to build trust, communicate and continue of this relationship. Investors and other users can benefit from a firm's profits for investment decisions and predictable cash flows and future profits correctly when the firm's profits is based on financial performance and it will be legible and clear, and not it should not be reported based on speculation management uses accounting methods. Therefore, a strong impetus of managers to falsifications and show a good image of the company may lead to unrealistic stock prices, irrelevant of accounting information and ultimately wrong decisions could be occurred. The aim of this study is to evaluate the effect on the legibility of earnings management accounting information, including earnings per share and its book value . Because the conscious actions have a negative effect on the earnings and book value per share and consequently the predictability and profit accounting were reduced and this leads to irrational decisions is invested. This study is review, and sum of 13 similar studies topic. Google Scholar databases was using of Scientific Information Database (SID) and the Science Direct website. Researchers will investigate various effects of earnings management and accounting information in different aspects . The results of this study will be discussed below. In the previous researches the only study that was similar is Lu et al (2017) in France and called earnings management and readability annual report. Among the Previous studies it is not found the internal study which will survey earnings management and readability of the annual report . in this regard It is suggested, few studies will do in Iran. Because the financial statements can be cleared.

Keyword:
profitability,Annual report readabilit, earnings management

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Introduction

in different countries accepted accounting standards allows managers to have a wide range of options to choose different methods of accounting to calculate the profit, at their disposal. However, managers may not use all the powers to fulfill the objectives of the company. Accruals relative are more in control of management than cash items constituting profit. In fact, business management can be flexible with the use of these methods authorized, and make the management of income closer to your goals(Khodadadi, Vali, Reza. Tucker and Mohammad Sadegh Zarezadeh, 1389: 53). Management aims is to show dynamic company and stable for investors and capital market. Because sometimes most of investors and managers believe that companies have good profitability And their profits have not been changed(Sajjadi, 1391: 23).

To be useful financial information for cash flows and profits, investors and creditors shall mean a series of qualitative characteristics in accordance with the Financial Accounting Standards Board (2) .

One of the basic features, is to read the annual report and financial information, including earnings per share and book value . Bloomfield (2002) stated that in companies with low financial performance, Managers are more motivated to obfuscate information. Li and colleagues study in 2008 had found that managers who have a clear vision of their company's financial performance , When they reached optimal performance, they are more willing in exposing the financial information and make a clear and readable information. Results of Lee and colleagues studies in 2008 has been shown that annual reports of companies that had poor performance is More difficult and complicated. They measured the readability of its annual report in two ways. The first variable,is the index is May computational linguistics literature that is the combined statistics of the number of words per sentence and the number of syllables per word.Index Meh Suggests that, whatever the number of words per sentence and the number of syllables are more,then a document is harder to read. The second measure is the readability of the annual report. These two variables are less expensive than other variables such as the processing of information. Their study was conducted in 50 thousand companies. Companies with less income are more likely to create files an annual report that is more difficult to read. In comparing with last year’s annual report, Increasing in revenue was seen easier too. Companies that had annual report was more sophisticated, and had more stable income. Companies that were easier to read the annual report, the words were used more positive. The results of the study by Lee and colleagues (2008) showed a significant relationship between readability annual report and financial performance of the company. The annual report is just one of the ways by which managers communicate with investors. Managers have severe limitations in communicating with investors, whereas the annual report readable way to build trust, communicate and continue this relationship(Bloomfield, 2002; Lee et al., 2008). Investors and other users can have benefitswhen a firm's profits for investment decisions and expectations of its previous approve be based on financial performance legible and clear, and it is not reported based on speculation management believes. Therefore, a strong impetus managers have to falsifications and show a good image of the company that else it will be lead to unrealistic stock prices, irrelevant of accounting information and ultimately wrong decisions (Habibi, 2004: 5).

The purpose of this study was to evaluate the effect on the legibility of earnings management accounting information, including earnings per share and book valu. Because the conscious actions have a negative effect on the earnings and the book value per a share . And consequently the predictability of accounting information and profit is reduced and this leads to irrational decisions investors.

Theoretical research

Readability annual report

The term readability, means the procedure for estimating the probability of success in the reader to read and understand a written text And readability company's annual report, which reflects the success of the procedure for estimating the reader in understanding the Company's annual financial report . Annual report as a document should disclosing financial information, should be committed to writing and other forms, so that it is easy to understand. Annual report of the company may be a company's most important financial information and represent optimal performance But if in such a way that it is difficult to understand the impact on the reader's mind will be 80%. This is efficient in promoting the company, and will be effective accuracy of annual reports (Lee, 2008: 56). Therefore, understanding the factors that make it difficult or easy to understand text And measuring the difficulty of understanding the text of the important issues that the study of Lee et al in 2006 it responded. They are especially compared the effective length of the sentence in the legibility of the report,and the number of syllables in the word of companies . The index was introduced in 1948 to determine the level of simplicity or difficulty factor is simply content by Rudolph F. Flash. This formula is designed based on two factors: the language, the average length of sentence and the number of syllables. Processes and procedures to evaluate and determine the reading level of the simplicity of materials, as follows:

1. Choose three hundred word from the elementary, middle and end of the text at random;
2. Determine the length of words by counting the number of syllables in the word chosen;
3. Count the number of sentences in a hundred words first, second and third;
4. Determine the average length of sentences by dividing the number of words to complete sentences of the text a hundred words;
5. Calculate the average length of words and sentences mean the average length of three hundred words of text;
6. Multiply the average length of words (the number of syllables) in a fixed number 846/0
7. Paragraph 6 of the deduction multiplied by a fixed number 835/206;
8. multiplied by the average length of sentences in a number 015/1;
9. subtracting the product of the remaining calculations paragraph 7;

10. The number obtained, is the degree of simplicity or complexity of the text to determine (Lee et al., 2006: 63).

Earnings management

After the Industrial Revolution and reduce the cost of production of goods and services, Investors and owners, were paid the salaries as a bonus to encourage and motivate them to provide better jobs (often based on a percentage of revenue) . Managers also have to operate optimally in order to get maximum profit for the company and consequently receive higher benefits.

After years of activity , Managers found out that they could use the principles and methods of accounting weaknesses, move and manipulate profits over time so that to obtain the desired profit reported in the financial statements, without shareholders are aware of the quality and quantity. This was the beginning of the earnings management or smoothing (Kashanipoor and Jacob, 1385: 87). Many researchers expert in the field of interest, the hip Worth to know that the first person to introduce smoothing (Dyfand and Jymbalv, 2006: 155). In general, the impact on corporate profits is earnings management, in a way that will meet the interests and demands of the company and its directors.

The main issue in financial misstatements and earnings management is , management's intention is not to provide objective evidence. Lack of standard-setting and regulatory bodies to issue earnings management, may indicate that this is not serious points of view and they believe that there is adequate supervisory procedures to prevent violations in the form of earnings management seems to be (Dastgir and NAZEMI, 1385: 16).

Readability of the annual report and management

Research shows that companies with poor financial performance, managers are more motivated to obfuscate information(Bemoghaled, 2002; Lee et al., 2008; Lee et al., 2006, Lu et al., 2017). Results of Lee and colleagues in 2008 showed that the annual of companies that had poor performance, difficult and complicated . Companies are less inclined to file an annual report that is more difficult to read. Increase in revenue compared to last year's annual report was seen as easier to read. Companies that have complicated annual reports, earnings were lower stability. All of these results were significant statistically. Companies that were easier to read the annual report, were used more positive words. The results of the study, Lee and colleagues (2008) showed there is a significant relationship between readability annual report and financial performance . Complex words are those having three or more syllables. Longer sentences and a higher proportion of complex words increase Fog, meaning a reduction in readability.

Methods: This study is a review and includes 13 studies which is similar to present topic. Databases used in this article are includes Google Scholar, Scientific Information Database (SID) and the Science Direct. Researchers in various investigators effect on earnings management and accounting earnings have investigated various aspects. The results of this study will be discussed below.

Found:

Lu et al (2017) in France to study under the management of income and legibility of their annual report. Their study found that companies were more profitable in a year, the disclosure of the annual report for that year is less readable. Companies that had more profit in a year have less income in its annual report. Gazer, Finn and Charles (2015: 39) concluded that earnings, book value and cash flows in an open market, to government markets have greater information content.

Gired, Nyousla and Satm (2009: 21) in their study concluded that relevance of accounting information during Chhlsalh to international accounting standards by increasing losses and intangible assets and the change in size of the company, has changed. Kapkn and others (2008: 9) to change the basis of this communication in different European countries reporting Reporting generally accepted accounting principles to International Reporting Standards, investigated and concluded that most of the companies that have made this change based reporting . Lee et al (2008: 53) study entitled readability annual report, current income, and income diligently attempted . Their study was cross-sectional. In this study, we studied 50 thousand companies.

Binvta and Soda (2005: 4) in their study concluded that the companies which involved in smoothing out than other companies of the relevance of earnings and book value and cash flow per share, respectively. Violin (2004: 63). With the impact of earnings management on the relevance of earnings per share and book value of the relationship between earnings management and valuation of the company. Violin believes that the long-term benefit management accruals through a greater impact on short-term accruals related to earnings and book value per share. Namra and violin (2004: 2) in their study showed that firms with earnings management to companies lacking, the profit is reduced. Habib (20004: 14) in their study of Japanese companies, concluded that negative correlation with the size of earnings management and accounting information, including earnings per share and book value . Liu and Zarvyn (1999: 354) argue that earnings management has no relationship with the book value per share .Markvard and Weidman (1987: 488) Effect of Earnings Management in the relevance of earnings per share and the book value of its stock price determination process is concluded in companies that profit management, relevance, especially in discretionary income is reduced.

To further explore these alternative explanations, obfuscation or ontology, and to better understand managers' use of complex disclosures, we look at instances in which firms are more likely to have managed earnings upwards to meet or beat an earnings target. In these cases, although firms are releasing good news about meeting a benchmark, they have incentives to hide the tools used to achieve it, as suggested by Warren Buffett. In other words, when reported performance differs from underlying fundamentals, we expect managers to try to make it harder for investors to identify such earnings management behavior and the underlying performance. Our results suggest that the readability level of financial disclosures goes beyond the one derived from the ontological explanation of good vs. bad news being disclosed. Instead, we find that managers strategically use corporate disclosure to mislead or to influence investors' understanding of firm's value. Khodadadi, Tucker and Zarezadeh (1389: 72) in their study investigate the effect of earnings management on the relevance of earnings per share and book value per share of discretionary accruals separating the short-term, long-term and paid the discretionary accruals. Samadi (1387: 89) also smoothing effect on the information content of its research on the subject found that smoothing Past and current earnings ability in predicting future earnings and operating cash flows will increase. Haghighatih and Azadi (1387: 33)will study the role of smoothing the earnings forecasts of future profits . The results of their study showed that the current stock price of companies that have more to income smoothing, contains information about earnings and future cash flows is less.

The earnings benchmark we use is the prior year's earnings (rather than earnings forecasts or zero earnings) because anecdotal evidence suggests that management's discussions in the annual report are more likely to compare and contrast performance in the current fiscal year with that in the prior year (or years). Forecasted earnings, whether by sell-side analysts or by management, are seldom referenced in annual reports. Zero and small positive earnings events are relatively infrequent, so we reserve this benchmark for supplemental analyses.[1] Moreover, small or zero earnings changes mean that performance this year was similar to that in the previous year so little explanation is expected by readers and provided by management. This idea is the basis for our null hypothesis–firms should provide disclosures that are easy to understand when their performance does not change much from previous year.

Variables

Dependent variable readability annual report

Readability of annual report is based on Lu et al in 2016 on the basis of the following model is obtained:

Readability = $\beta 0 + \beta 1EM + \Sigma\beta j$ Control + ε

EM: refers to earnings management

Control: refers to control variables

Readability annual report:

To measure the annual report readability index used Foxx Gong.

Fog = 0.4 × (words per sentence + percent of complex words)

words per sentence refers to the number of words in a sentence

percent of complex words refers to the percentage of complex words

Complex words are the words with three or more syllables. Long sentences and complex words Foxx index increases the readability decreases (Miller, 2010: 2107).

Independent variables: earnings management

Total ACCrt / TA t-1 = $\alpha 0 + \alpha 1$ (1 / TA t-1) + $\alpha 2$ (Rev / TA t-1) + $\alpha 3$ (PPE / TA t-1)

Total ACCrt is all accruals.

Rev change in revenue annually.

PPE gross property, plant, and equipment.

TA t-1 Total assets at the end of the year.

Conclusion: In previous studies the only similar study that has been found is the study of Lu et al (2017) in France as earnings management and readability of annual report. Among the previous studies it has not been found any internal study examined earnings management and readability of annual report . In this regard, It is suggested that few studies will done in Iran. Because the financial statements in this regard can be found in Iran

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