

CHAPTER I

INTRODUCTION

1.1 Background

Annual report has an important role on organization. Go Public companies have to report their management information to Indonesia Stock Exchange (IDX) through annual report. Annual report represents the company's condition in a year and it also signs as accountability to stakeholders. There is some information that informed in annual report such as information about company's achievement in a year, describing about job description of each job area, the corporate governance structure and also financial statement. The annual report also regulated on OJK regulation number 29/POJK.04/2016 that stated annual report must be published in Indonesian language and foreign language at least English and the information that given must be same with the information in Indonesian language. It is because of investors in public companies is not only from Indonesia but also from other country. As mentioned before annual report is contained of financial statement, based on IAS 1 the financial statement must present fairly the financial position, financial performance and cash flows of an entity, so do for the annual report it must be present the fair presentation of the firm condition and performance.

Readability issues in annual report is one of topic that need to be concerned because it relates with the effectiveness of giving information to the annual report user. Investor and stakeholders analyze the current condition of financial,

performance, cash flow and evaluate of company's growth prospects and management performance through annual report (Luo, Li, & Chen, 2018) . Readability is an important dimension of the quality of communication between authors of financial reporting and the readers (Courtis, 2004). Readability is positively associated with effective communication (Courtis & Hassan, 2002; Subramanian, Insley, & Blackwell, 1993) and found to affect the outcome of analysts' forecasts (Lehavy, Li, & Merkley, 2011). Luo, Li, and Chen (2018) stated that information that given in annual report is good if the level of readability is high. Firms with poor performance are harder to read, whereas firm with a higher level of readability of annual report have more persistent positive earnings (Li, 2008). Asay et al. (2018) analyzed how corporate managers select their language style in two different settings, which vary in both the sign of the firm's performance and the strength of self-enhancement motives (i.e. the desire to make the company look more favorable). They assume that managers with a stronger motive for self-enhancement might decrease the readability of bad news to obfuscate poor performance and increase the readability of good news to present good news.

Relationships with various stakeholder groups like customers, employee and the community affect firm performance whether or not those stakeholder groups share in ownership rights. Successful relationship between the manager and stakeholder are based on trust and trust is created and maintained by meeting and exceeding responsibilities to stakeholders, in this process, corporate governance

play important roles (Stuebs, M & Sun,L , 2015). The structure of corporate governance that consists of board of commissioners, audit committee, board of directors has their own role in a firm. Prior studies examining corporate performance as one of the primary factors affecting readability of annual report (Li,2008) neglect the potential role of a firm's management and its board composition in influencing both the firm's performance and the complexity of text communication annual reports (Hooghiemstra *et al.*,2017).

There are some ways to measure readability of an annual report which are Flesch reading ease, Flesch Kincaid grade level, Gunning Fog index, Automated Readability Index (ARI), SMOG Index, etc. In this research, the researcher used Gunning fog index as the tools to measure the readability. To measure Fog, it focuses on financial statements notes as a key component of corporate reporting (Kieso *et al.*, 2013). Gunning fog index was chosen in accordance with prior studies that (e.g. Miller, 2010; Lehavy et al., 2011; Rennekamp, 2012; Loughran and McDonald, 2016), measures corporate reporting readability using the Fog Index. The corporate governance measured by proxy of frequency of size of audit committee, size of board commissioners, frequency meeting of board of directors.

The existence of effective board of commissioners and audit committee should have a positive impact on good corporate governance practices. Yi et al. (2010) find that the board and audit committee characteristics have negative effects on fraud in the financial report. The main purpose of the audit committee function is to ensure the quality and the reliability of financial report

(Kusumawati & Hermawan, 2013). Therefore, the likelihood of accounting fraud should be reduced by an audit committee which performs effectively. Persons (2005) finds some aspects of the audit committee, such as whether the member of the audit committee is the director of another company and the tenure of this audit committee member, have a direct implication towards the improvement of the corporate governance in the future.

One of the internal governance structures is the board of commissioners who has the main function to supervise and monitor the management action. The objective of good corporate governance can be achieved if the board of commissioners can perform their responsibilities effectively (Kusumawati & Hermawan, 2013). The role of the board of commissioner are explained in more detail in Law Number 40 of 2007 article 108 paragraphs 1 and 2, which stated that the board of commissioners oversees management policies, management processes in general, both regarding the company and the business of the company, and provides advice to directors for the benefit of the company and in accordance with the aims and objectives of the company.

Li (2008) finds a positive relation between Management Discussion & Analysis (MD&A) readability and profitability, i.e. firms with lower earnings have less readable MD&A, and interprets this as evidence that low profitability firms obfuscate. MD&A is part of annual report that required by SEC and also IASB to be included in public company's annual report. While in research that conduct by Curtis (1995) stated that there is no correlation between profitability

and readability. Profit is defined as one of the indicators to measure the good performance of a firm, it is also used as an indicator for investor to make a decision.

One of the annual report parts that might be the most read is Management Discussion and Analysis (MD&A) section, in this section the company reports the aspects such as financial review, business review, industry review, performance of company's subsidiaries and the prospects of business for the next year. Management Discussion and Analysis considered representative in reporting summaries of overall report. As stated on the paragraph above to measure fog it focuses on financial statement notes, but in this research will be different, the researcher will use the MD&A section to be measured by Fog Index.

Profitability is the firm's ability to make profit through their operational activities. Profitability can be seen from 3 perspective which are Return on Asset (ROA), Return on Equity (ROE), and Return on Investment (ROI). Profitability can be considered as important things for investors in making decision, the higher level of profitability shows the good perspective of a firm. When determining how to present information to investors, firms trade off maximizing expectations of future cash flows, which increases stock price, and minimizing information risk, i.e., investors' concerns that they are not fully informed, which increases the cost of capital and decreases stock price. When firms have negative information, making this information less (more) accessible yields higher (lower) expectations of future cash flows, but also higher (lower) information risk. The relation

between readability and profitability depends on how firms make this tradeoff (Gee, 2017).

In this research the researcher using profitability and corporate governance as the independent variable and readability of annual report as the dependent variable. This research is an empirical study where the sample that will be used is the service company sector that listed in Indonesia Stock Exchange on 2016-2018. The reason for this research is choosing a service company as the object of research because now service companies are growing rapidly, this can be seen by many people who needs services, consumers will be using the services they offer.

1.2 Problem Formulation

Based on the explanation that describe in the background, the problems that will be formulated were as follow:

1. Is there any influence of profitability on readability of annual report?
2. Is there any influence size of audit committee size on readability annual report?
3. Is there any influence of board of commissioner size on readability of annual report?
4. Is there any influence of frequency meeting board directors on readability of annual report?

1.3 Research Objectives

Based on the problem formulation above, the objective of this research is as follows:

1. To know whether there is any influence of profitability on readability of annual report
2. To know whether there is any influence of size audit committee on readability of annual report
3. To know whether there is any influence of size of board commissioners on readability of annual report
4. To know whether there is any influence of frequency meeting board of directors on readability of annual report

1.4 Research Benefit

This research is expected to be beneficial to:

1. For the author, this research will give knowledge and understanding related to the influence of profitability and corporate governance to readability of annual report. In addition, this research also purposed for the author as the requirement to achieve Bachelor Degree of Accounting in Andalas University.
2. For the investor/ creditor, this research will give the information and reference regarding readability of annual report and to do some investments or credits activity to the company.
3. For accounting knowledge and subsequent researchers, as a researcher hopes this research will provide the information needed regarding to the

influence of profitability and corporate governance to readability of annual report. Also, as a reference for the subsequent researchers.

4. For the public companies, this research is aim to give information that the readability needs to be considered in preparing annual report so that the purpose of delivering information is achieved.

1.5 Writing Systematic

This research will consist of 5 chapters and the writing systematic used in this research is:

CHAPTER I: BACKGROUND

This chapter is an introduction part which is discussed the background, problem formulation, research objectives, research benefits and writing systematic.

CHAPTER II: LITERATURE REVIEW

This chapter is literature review which is discussed about the theory used in this research, previous research and theoretical framework.

CHAPTER III: RESEARCH METHOD

This chapter is research methods which is discussed about research design, population and sample, type and source of data, data collection method and analysis method

CHAPTER IV: RESULTS AND DISCUSSION

This chapter discuss about the description of the research object and analysis as well as discussion of the research results regarding influence of profitability and corporate governance to readability of annual report.

CHAPTER V: CONCLUSIONS

Conclusions are drawn from the research results, limitations of this research, and also the suggestions for further research.

