THE EFFECTS OF ANNUAL REPORT READABILITY ON THE AUDIT FEES

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ABSTRACT

This research aims to examine and analyze the effects of the readability of annual reports on audit fees. The research was conducted on public companies in Indonesia. Readability is measured using a document length proxy, assuming that the longer the document, the lower the report's readability. This study shows that document length positively affects audit fees or vice versa. Report readability has a negative effect on audit fees. The results of this study support the signaling theory. The report's readability can be used as a signal by the auditor in considering the audit procedures to be carried out. The less readable the company's report is, the more likely it is the possibility that the company can keep unfavorable information secret, which will impact audit procedures and costs.

Keywords: Readability; Annual Report; Audit Fee

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ABSTRAK

Riset ini bertujuan menguji dan menganalisis pengaruh keterbacaan laporan tahunan terhadap biaya audit. Penelitian dilakukan pada perusahaan publik di Indonesia. Keterbacaan diukur menggunakan proksi panjang dokumen dengan asumsi semakin panjang dokumen, semakin rendah keterbacaan laporan. Penelitian ini menunjukkan panjang dokumen berpengaruh positif terhadap biaya audit, atau sebaliknya, keterbacaan laporan berpengaruh negatif terhadap biaya audit. Hasil penelitian ini mendukung teori sinyal. Keterbacaan laporan bisa dijadikan sinyal oleh auditor dalam mempertimbangkan prosedur audit yang akan dilakukan. Semakin rendah keterbacaan laporan perusahaan, semakin tinggi kemungkinan perusahaan dapat merahasiakan informasi yang tidak menguntungkan, yang pada akhirnya akan berdampak terhadap prosedur dan biaya audit.

Kata Kunci : *Keterbacaan; Laporan Tahunan; Biaya Audit*
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INTRODUCTION

The importance of the role of the annual report in providing information for stakeholders is stated in the Financial Services Authority Circular Letter No.16/SEOJK.04/2021 concerning the Format and Content of Reports from Issuers or Public Companies. The annual report is a crucial source of information for shareholders and investors as one of the critical factors in making investment decisions and a way to monitor issuers or public companies. The Board of Directors and the Board of Commissioners are required to provide qualified, accurate, and accountable information through the annual reports of the issuers or public companies following the development of the capital market and the growing need for investors or shareholders to disclose information. Regular and informative annual reports can help investors, shareholders, and other stakeholders.

Based on existing regulations, companies must be able to provide annual reports that are easily understood by readers so that the objectives of making annual reports can be achieved. Information disclosure should be an absolute must for the companies in conveying important information to the stakeholders. The annual report prepared by the company should have characteristics according to the conceptual framework of financial reporting. One of these characteristics is that the report can be understood (understandability) by the users, which becomes the basis of the importance of the report's readability.

Readability is the ease of understanding text related to the writing style (Rahman & EDT, 2020; Rahman & Kartika, 2021). Several studies have linked the readability of annual reports to the decisions of investors and creditors. (Abernathy et al., 2019); (Boubaker et al., 2017); (Loughran & McDonald, 2016) shows that the disclosure of less understandable information will damage the investors' ability to process the information, resulting in a decrease in the liquidity of the company's shares. (Abernathy et al., 2019) revealed that the level of efficiency and effectiveness of the investors in using the information is influenced by the textual readability of information in financial statements. Low readability can reduce the usefulness of financial statements for investors.

As corporate governance stipulates to ensure the accountability of the financial statements presented by the company, the financial and annual reports issued by the company must be audited by an independent auditor. In addition, auditors also have a significant public role in financial markets by assuring the credibility of accounting information. It leads to a better allocation of resources and increased audit engagement efficiency (DeFond & Zhang, 2014). In performing audit procedures, the auditor is required to be able to assess the existing audit risk. Auditors will incorporate into their risk assessment, and according to their fee structure, the nature and content of the risk disclosure.

Based on signal theory (Spence, 1973), this study links the readability of annual reports with audit fees. Spence (1973) states that company management has better information about the company and will be encouraged to convey information through signals to attract investors and vice versa. Whelan (2015) states that signal theory is closely related to communication between two parties with information asymmetry, so it is beneficial for managers to explain the decisions that have been taken (Yasar et al., 2020). Company management signals stakeholders about the company's good or bad performance to be used to make company projections for the future.

Referring to the signaling theory, the readability of the company's annual report is expected to signal to the auditors about the company's condition. The auditor is considered to use the report's readability to determine the number of fees or audit fees. The readability of the annual report is considered one of the company's management cues to the auditor regarding the company's performance and condition so that the auditor can estimate the audit procedures to be carried out. Low readability of annual reports is associated with greater audit risk (Bonsall & Miller, 2017) and more excellent audit time and costs (Cho et al., 2022; Abernathy et al., 2019; Jang & Rho, 2016). Financial and annual reports with low readability will result in longer audit delays and higher audit fees due to higher audit efforts by the auditors (Abernathy et al., 2019). Based on the impact of report readability in influencing the decisions of various parties, including the auditors, this study aims to empirically prove the role or relevance of the readability of the annual report on the audit fee decisions charged by the auditors.

If the influence of accounting numbers in the company's financial reports has been widely studied by previous researchers, research related to textual analysis or narrative of company reports is currently a research area that is still very developed. Narrative reports published by companies, suspected and proven by previous studies (Abernathy et al., 2019), (Boubaker et al., 2019), (Soepriyanto et al., 2021), can influence the decisions to be taken by various stakeholders, including auditors. While several previous studies have focused on assessing the readability of reports related to investor or shareholder responses, few studies have examined the relationship between readability and auditor responses. Independent parties are required to ensure the accountability of reports containing company financial information.

METHOD

A population is a group of individuals or events that have specific characteristics. At the same time, the sample can be defined as part of the population representing the population used in the research. The population in this study were all companies listed on the Indonesia Stock Exchange in 2018-2019. Company samples were selected by purposive sampling or by eliminating samples based on specific criteria and conditions. The criteria used in selecting the sample are shown in Table 1.

Table 1. Sample Selection Criteria

Criteria	Number
All Indonesian public companies in 2018-2019.	1148
Annual reports of companies that do not disclose audit fees.	(529)
The companies that do not have complete data and documents for research variables.	(44)
Total Number of Sample	575

First, all companies listed on the Indonesia Stock Exchange during 2018-2019. This study does not include data from 2020 during the pandemic, so there is no bias. During the pandemic, it is predicted that the narrative information of the annual report will contain more arguments for the exceptions. Second, the available data is complete, which includes disclosure of audit fees and other supporting data required in the 2018-2019 annual report.

The research data are obtained from the annual reports of all public companies, which can be accessed through the website www.idx.co.id and the company's official website. This research uses a multiple linear regression analysis research model by explaining the relationship between variables. The measurement of this research variable is described in Table 2. The following research model is used.

$AFee_{i,t} = \alpha + \beta 1Readability_{i,t} + \beta 2Size_{i,t} + \beta 3Profitability_{i,t} + e_{i,t}$…...................(Equation 1)

Description:

$Afee_{i,t}$	= Audit fee of the company i in year t as measured by ln (audit fee)
α	= Constant
β123	= Regression Coefficient X123
$Readability_{i,t}$	= readability of company i report in year t as measured by natural logarithm (ln) the number of report pages
$Size_{it}$	= Company size i in year t as measured by ln (total assets)
$Profitability_{i,t}$	= Profitability of company i in year t as measured by the value of ROA
e	= Error

Table 2. Variable Measurements

No	Variable	Variable Definition	Measurement
1	Audit Cost	The audit fee is the total fee paid by the company to KAP.	A fee is measured by the natural logarithm value of the ln audit fee (audit fee) (de Souza et al., 2019; Salehi et al., 2020).
2	Readability	Readability assuming the length of the document will increase the cost of reading and processing relevant information for the recipient of the information. It means that the longer the document (, the more pages), the lower the readability of the report, and vice versa.	Readability is measured by ln (number of pages). The measure used is inversely related to the variable name (de Souza et al., 2019; Salehi et al., 2020).
3	Company Size	Several things, such as total assets, total sales, and average sales, can determine the company's size.	Firm size is measured using the natural logarithm of total assets ln (total assets) (Salehi et al., 2020).
4	Profitability	Profitability results from the company's management performance in managing its resources following established policies.	Profitability is measured by the value of the company's Return on Assets (ROA) (Salehi et al., 2020).

RESULT AND DISCUSSION

Descriptive Statistics

The purpose of descriptive statistical analysis is to determine the general description of the variables used in the study. In table 3, it can be seen that the readability has a minimum value of 31, which PT owns. KDB Tifa Finance Tbk (TIFA) in 2019. The highest maximum value was obtained at 1331, owned by PT. Bank Rakyat Indonesia Persero (BBRI) in 2019. The average value of the readability variable is 318.09, and the standard deviation is 199.042. It means that readability has good results because the standard deviation that reflects the deviation is lower than the average value. The readability is measured by using the length of the document (number of pages), which can be seen in the company's annual report.

Firm size as a control variable in this study shows a minimum value of 15.7675 and a maximum value of 34.8871, each owned by PT. Barito Pacific Tbk (BRPT) in 2018 and PT. Bank Rakyat Indonesia (BBRI) in 2019. The higher the value of the company size, the higher the assets owned by the company.

Profitability as a control variable in this study is measured by the rate of return on assets or return on assets (ROA). The test results show that the minimum ROA value is -1.4653, owned by PT. Leyand International Tbk (LAPD) indicates that the company is experiencing a loss. PT owns the maximum value of 0.6072. Tiga Pilar Sejahtera Food Tbk (AISA) in 2019 indicates that the company has the highest rate of return on assets. The average value of the profitability variable is 0.136650, and the standard deviation is 0.01347965. Audit fee as the dependent variable in this study has a minimum value of 17.5997 owned by PT. Pelat Timah Nusantara Tbk (NIKL) in 2018. For a maximum value of 24.8025, it belongs to PT. Telkom Indonesia (Persero) Tbk in 2019, of which this company is the company with the highest audit fees.

Table 3. Descriptive Statistics

Variable	Minimum	Maximum	Mean	Std. Deviation
LDoc (XI)	31	1331	318,09	199,042
Firm Size	15,7675	34,8871	27,532482	37772135
Profitability	-1,4653	,6072	,136650	,01347965
Audit Fee	17,5997	24,8025	20,395911	1,1516084

In addition to analyzing the research data through descriptive statistics, it is in Table 4 below. The Pearson Correlation test is presented to assess the relationship between research variables.

Table 4. Pearson Correlation Test

	LDoc	Firm Size	Profitability	Audit Fee
LDoc	1	.339**	-.043	.394**
		(.000)	(.299)	(.000)
Firm Size	.339**	1	-.085*	.256**
	(.000)		(.042)	(.000)
Profitability	-.043	-.085*	1	-.018
	(.299)	(.042)		(.668)
Audit Fee	.394**	.256**	-.018	1
	(.000)	(.000)	(.668)	

From the Pearson Correlation test, it can be seen that the variable length of the document (a proxy for readability) has a significant positive relationship with firm size and audit fees but does not appear to have a relationship with profitability. This Pearson Correlation test implies that the relationship between document length (LDoc) and Audit Fee is assumed that the longer the document, the lower the readability of the report, and the higher the company's audit fee.

The next test to answer the research objectives is to analyze the partial effect test (t-test). The t-test aims to see whether the independent variable (X) partially affects the dependent variable (Y). The results of this partial significance test can be seen in the following table.

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Table 5. Research Findings

Variables	Coefficient	t-value	Sig
(Constant)	18,620	57,933	,000
LDoc (X1)	,002	8,425	,000
Firm Size (X2)	,041	3,362	,001
Profitability (X3)	1,182	3,665	,000

The Effect of Report Readability on Audit Fees

Currently, the attention of the economic community is focused on the readability of the annual report. Regulators establish various rules to ensure the readability of the annual reports of public companies or issuers. SFAC No. 8 point 1 states that one of the characteristics that companies must meet in preparing an annual report is the ease with which users can apprehend the report. To ensure ease of understanding for users of the report, the annual report should contain not only narrative text but also pictures and graphs as well as figures to provide financial and non-financial information. In addition, the annual report design can also be prepared in various formats, from basic typed pages to colorful and attractive publications.

The issue of the readability of this report is essential because it can influence the decisions taken by various parties. Research by Boubaker et al. (2019) shows that disclosure of less understandable information will destroy investors' ability to process the information, which can result in a decrease in the liquidity of the company's shares. Abernathy et al. (2019) prove that the readability of textual information in financial statements influences investors' efficiency and effectiveness in using information. The achievement of the objective of making annual reports for stakeholders such as investors occurs when the annual report can be used as an analytical tool and a basis for consideration in making investment decisions.

Unfortunately, when a company has information asymmetry, the annual report may be prepared to obscure that information to the stakeholders. Abernathy et al. (2019), who tested the legibility of footnotes, found that the complexity of footnotes reflects the management's attempts to hide the bad news. Management deliberately submits reports using complex and ambiguous language to cover the company's poor performance (Rahman & EDT, 2020). It is common for companies to deliberately lower the readability of their reports to trick the report users into not knowing the information that the company wants to keep private.

Based on signal theory (Spence, 1973), the level of readability of information in the annual report submitted by the company's management will signal to the auditor that the company is trying to cover up information that it does not want to be disclosed. It encourages an increase in the audit effort required by the auditor, which is expected to impact the audit fees charged by the auditor.

The results of this study prove that the readability of the annual report affects audit fees. The direction of the findings of this study shows that the longer the company's annual report, the lower the readability and the higher the audit fee. On the other hand, the more concise the report (, the higher the readability of the report), the lower the audit fee. When the readability of the annual report is low, the company can hide unfavorable information, so it takes more time for the auditor to obtain the information submitted by the company. Low report readability will increase audit risk. Therefore more and more audit efforts and procedures are needed in conducting an audit. As a consequence, the audit fee set by the auditor is higher. Today's auditors tend to be more aware of the opportunistic behavior of company management that seeks to obscure information, so auditors respond to these risky actions by increasing audit fees.

Salehi et al. (2020). Blanco et al. (2021) and Abernathy et al. (2016) found that readability, comprehension, and notes of financial statements were considered factors in determining audit fee decisions. If managers are expected to deliberately manipulate the quality of textual information to mislead stakeholder decisions, it will eventually lead to the imposition of some agency costs for the company. Low readability of annual reports will increase the client's risk, namely the risk of survival and client profitability (DeFond & Zang et al., 2016). Managers who tend to manipulate adverse information and conceal it with ambiguous and illegible disclosures (Bloomfield, 2005; Li, 2008) exacerbate business risks for clients. These risks can also be increased by manipulating information about the company's future unprofitable operations, which better explanations, disclosures, and elaborations can remedy. Abernathy et al. (2019) show that the legibility of footnotes is associated with a greater likelihood of financial misstatements and future accounting-related disputes. Auditors respond to these risks by appointing several procedures to correct potential risks. The auditor will respond to the increase in client risk due to the readability of this report with an increase in audit fees.

Furthermore, this study supports the effect of company size and profitability on audit fees. Companies with a large size, seen from a lot of total assets, are proven to have high audit fees because they have high report complexity. Larger companies have less legible annual reports (Blanco et al., 2020). It results in the auditor having to increase audit efforts to reduce errors that cannot be detected so that audit risk can be reduced (Liu et al., 2020). Companies with high profitability illustrate that the transactions carried out by companies are high, so the auditors must be more skeptical of large companies, which will ultimately impact increasing audit fees.

CONCLUSION

This study examines and analyzes readability's effect on audit fees. The test results of this study found that document length had a positive effect on audit fees. This study uses document length as a proxy which has an inverse relationship with report readability. In other words, the results of this study indicate that the readability of the annual report has a negative effect on audit fees. These results support the signaling theory used in the study. The low readability of the annual report can be a signal to the auditor that there is a possibility that the company is trying to keep unfavorable information secret. Thus, encouraging the auditor to carry out broader, more careful audit procedures and more evidence will increase the audit fees. This study also supports the effect of company size and profitability on audit fees. Larger companies tend to have annual reports with high complexity, so they have low readability and require the auditors to estimate longer audit times and higher audit fees. Furthermore, a company's profitability indicates that the transactions are getting bigger, so auditors must be more skeptical in auditing company reports to reduce undetected risks and impact audit fees. The results of this study imply that the readability of the company's annual report can influence report users' decisions, including auditors.

It is undeniable that in conducting this research, there are still limitations and obstacles. There are many alternatives for measuring report readability. This study uses one document length measure. Adding proxies to measure the readability is highly recommended to determine broad readability, such as the size of the annual report file and the number of words and sentences in the annual report. This study

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uses two control variables, namely, the company size and the profitability. The period used in this research is two years, namely 2018 and 2019. In future research, the researchers can expect to extend the time to obtain more data and complete results.

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