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Investigating the Effect of Profit Predictability Criteria and the Relevance of Financial Information on the Readability of Companies' Annual Reports[1]

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Research Paper

INTRODUCTION

In the last decade, many observers of financial markets have paid special attention to the importance of the readability of financial and accounting texts. Since the concept of readability enhances the qualitative characteristic of comprehensibility in financial information, it is necessary to evaluate the impact of information readability on the decisions of stakeholders, especially investors (Moradi and Matinnazar, 2017). One factor that has heightened attention to readability is the change in companies' disclosure requirements, which has significantly increased the provision of explanatory information and directed investors' focus to the readability of companies' annual reports. Several studies indicate that the readability of annual reports can affect the quality of information disclosure. One of the main aspects researchers have explored in this field is the economic consequences of improving the readability of annual reports.

Theoretically, since management and ownership are separated in joint-stock companies, annual reports serve as a bridge between management and external shareholders. Through these reports, investors and minority

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shareholders can obtain information about the company's financial status, performance, cash flows, and growth prospects, enabling them to assess its management. Unfortunately, in recent years, the decline in the readability of annual reports has negatively affected their effective communication with investors and minority shareholders.

This research seeks to examine the readability of annual reports as a criterion for measuring the quality of financial information and its relationship with the criteria of profit predictability and the relevance of financial information, which are recognized as measures of profit quality. The main purpose of this study is to build on previous research by evaluating whether profit predictability and the relevance of financial information influence the readability of annual reports.

METHODOLOGY

In this research, the theoretical foundations were gathered using library sources, and the necessary data to calculate the research variables were extracted from market information and financial data. This study is of the post-event type, as it uses past data and information to test hypotheses. Theoretically, it falls into the category of deductive and inductive research and is classified as quasi-experimental research in the field of financial and accounting studies. The required information was collected from the financial statements and accompanying notes of sample companies listed on the Tehran Stock Exchange, extracted from the archives of the Tehran Stock Exchange website. To facilitate data extraction, the latest software was utilized, and the data were then processed using Excel and SPSS software to test hypotheses and perform supplementary tests to ensure the validity of the independent regression model. Additionally, EViews software was used to analyze the data more precisely and run the regression model.

STATISTICAL POPULATION

Due to the large size of the statistical population and inconsistencies among its members, the systematic exclusion method was used to select the sample. Accordingly, 71 companies listed on the Tehran Stock Exchange from 1390 to 1400 (equivalent to 2011–2021, spanning 11 years) were selected as the statistical population of this research, totaling 781 company-years. This selection was based on the availability of financial information quality scores for these companies over 12-month periods.

READABILITY (DEPENDENT VARIABLE) (FOG)

In this research, the dependent variable is the readability of financial reporting, measured using the Fog Index. This index aligns with the methodologies of Yu and Zhang (2009), Lawrence (2013), Ajina et al;

Fazal Elahi (1389) and Dayani (1379), and its validity has been confirmed in these studies.

PREDICTABILITY OF PROFIT (CFO)

This feature evaluates the degree of change in net profit. The more stable and less volatile the net profit, the smoother it is, allowing for more accurate predictions of future profits.

RELEVANCE (RET)

Relevance refers to the ability of profit to explain changes in returns or stock prices.

DISCUSSION AND CONCLUSION

At the outset of the research, we examined and analyzed the results of the models presented for the hypotheses. Given the similarity of the Fog Index in two different models in English and Persian languages, we concluded that the readability of commercial texts plays a significant role in the quality of profit reporting for companies listed on the Iranian Stock Exchange. These findings can serve as a practical model for other companies, demonstrating that readable financial reports can enhance transparency and trust in financial reporting.

In the first hypothesis, we investigated whether the readability of financial statements of listed companies is affected by profit predictability. The results confirmed this hypothesis, showing that companies with more predictable profits tend to produce more readable financial reports. This suggests that profit predictability can improve the structure and quality of financial reporting.

Following the confirmation of the first hypothesis, we explored the effect of another criterion: the relevance of financial information. In the second hypothesis, we aimed to determine whether the relevance of financial information influences the readability of companies' annual reports. The results indicated that this criterion also positively affects report readability. These findings strongly suggest that financial information more relevant to users' needs and expectations is likely to be presented with better readability. Therefore, with both hypotheses confirmed, it can be concluded that profit predictability and the relevance of financial information play key roles and significantly impact the readability of financial statements. These criteria not only enhance the transparency and accuracy of reports but also improve their usability and comprehension for shareholders and other stakeholders. These results can guide companies in improving the quality of their financial reports and increasing transparency in Iran's financial markets. This research aims to contribute to a more comprehensive literature in the field of linguistics and hopes to be of use to those interested in this area.

Based on the results of the hypothesis tests, this study appears to contribute to the growing literature on the impact of readability on investors' decisions, enriching the body of knowledge on this subject in Iran and its capital market, both directly and indirectly. In particular, the findings underscore the need for the Securities and Exchange Organization to develop guidelines similar to those of the U.S. Securities and Exchange Commission to enhance the readability of financial statements for domestic investors.

Keywords: Readability of Financial Statements, Profit Awareness, Profit Transparency.

JEL Classification: M41.