

# Earning Opacity, Ceo Overconfidence, Financial Report Readability Effect On Stock Price Crash Risk

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## ABSTRACT

Stock price crash risk is the sudden and drastic drop in share prices that occurs when negative news about a previously hidden issuer emerges. One of the cases of stock price crash risk that is sticking out is the case of Bear Stearns Companies Inc., a global investment bank as well as a brokerage and securities trading company in the United States. Wen (2016) shows that the problem of stock price crash risk is also influenced by earning opacity, CEO overconfidence and financial report readability. The purpose of this study was to examine and analyze the effect of earning opacity, CEO overconfidence and financial report readability on stock price crash risk.

Based on the objectives, this study uses a design explanatory research (hypothesis testing) with the causality approach which aims to explain causal relationships. The unit of analysis in this study is an Indonesian manufacturing company listed on the IDX for the period 2014-2017 or the period after the 2013 economic crisis in Indonesia due to the pressure of the rupiah depreciation and rising inflation. The analysis technique in this study uses multiple linear regression analysis.

The results obtained in this study are (1) Earning opacity positive effect on stock price crash risk; (2) CEO over confidence positive effect on stock price crash risk and (3) Financial report readability positive effect on stock price crash risk

## Keywords

Stock price crash risk, earning opacity, CEO overconfidence, Financial report readability

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## Preliminary

*Stock price crash risk* is the drastic and sudden drop in share prices that occurs when negative news about previously hidden issuers surfaced (Wen, 2016; Bleck & Liu, 2007; Jin & Myers, 2006). One of the cases of stock price crash risk that is sticking out is the case of Bear Stearns Companies Inc., a global investment bank as well as a brokerage and securities trading company in the United States (New York Times, 2008). Bear Stearns has been investing in the sub-prime mortgage market since 2003 after the government deregulated consumer protection and derivatives trading.

The business collapsed in 2008 because more and more customers were unable to meet their mortgage obligations, as did Bear Stearns. After previously hitting a high share price of \$ 133.2 per share in the 52 weeks before the crisis, Bear Stearns was finally sold to JP Morgan Chase & Co. for \$ 10 per share in March 2008. The measurement of stock price crash risk is based on firm-specific stock returns as measured by the residual model of company stock returns after removing the effects of changes in market returns and industry returns at the time of observation, prior, and thereafter (Wen, 2016; Bradshaw et al., 2010; and Hutton et al., 2009). Wen (2016) shows that stock price crash risk is also influenced by earning opacity.

Apart from earning opacity, stock price crash risk can also be influenced by CEO overconfidence and financial report readability (Bhattacharya et al., 2003 and Khadafi, 2014; Wen, 2016, Zhao & Ziebart, 2017; Nguyen & Kimura, 2018, Luo et al., 2018; Guiso, Sapienza, & Zingales, 2008 and Sapienza & Zingales, 2012; and Lamoreaux et al.,

2015). Overconfidence (optimistic bias) is shown as a normal and systematic tendency for everyone to be overly optimistic about the results that will be received in the future, especially for those who have significant influence or control (Zhao & Ziebart, 2017; Armor & Taylor, 2002).

In company management, the tendency of executives to be overconfidence can damage financial decisions. CEOs who are overly confident tend to overestimate their own abilities, ignore competitors' abilities, and underestimate competitors' counter strategies. Likewise, overconfidence will lead to overinvestment, such as: excessive market penetration (excess entry into the market), deeper financing of mergers and acquisitions (overpayment), decrease in company value after mergers and acquisitions (value-destroying), and expansion of operational capacity that is not prudent (Zhao & Ziebart, 2017).

In the case of the impact of CEO overconfidence on more financing in acquisitions, Zhao & Ziebart (2017) cited the case of the acquisition of Network Solutions Inc. by VeriSign Inc. in the United States with an acquisition cost of \$ 21 billion which VeriSign Inc. sold three years later. for just \$ 100 million. VeriSign Inc. executives too optimistic to estimate a large profit increase from the acquisition of 8.1 million Network Solutions Inc. customers. in the Network Solutions Inc. business, which could then be used to sell VeriSign Inc. products. Analysts believe that the huge acquisition costs should have been avoided at a lower cost through a partnership strategy. Zhao & Ziebart (2017) also show that the market discounts CEO overconfidence by increasing the cost of credit, likewise integrating it in a higher bond price. In its measurement, CEO overconfidence

is measured based on the degree of CEO optimism in predicting earnings (management earning forecasting) where the CEO is considered overconfidence if actual earnings per share (EPS) do not reach the predicted EPS.

In a business context, readability is the ability of individual investors and analysts to assimilate relevant information from the financial disclosure of a report for valuation purposes (Nguyen & Kimura, 2018; Loughran & McDonald, 2014). In the financial report, readability is measured in the Management Discussion & Analysis (MD&A) section, which is the company's financial report section where management discusses and analyzes various aspects of the company, including its performance, current financial conditions, and future projections. The information in the MD&A helps potential investors to understand the company's financial fundamentals and management performance. Apart from affecting corporate agency costs, the research results of Luo et al. (2018) show that financial report readability also affects market reactions.

However, the Fog Index has limitations because the Fog Index measures financial report readability based on the calculation of words per sentence and complex words on MD&A. Thus, in the Fog Index, readability is only measured as the grammatical quality of the content of financial information. As referring to the readability limits of Nguyen & Kimura (2018) and Loughran & McDonald (2014), financial report readability can be more represented by the level of information relevance of a financial disclosure. The existence of a standard MD&A information completeness in public reporting, as regulated by the capital market authority, allows the development of a financial report readability measure based on the proxy for the level of relevance of measurable information completeness as a mandatory readability index.

## Theoretical review

### a. Stock Price Theory

As an investment in financial assets, stock investing is a type of investment that is in great demand. Shares are a sign of an individual's or party's (business entity's) capital participation in a company or limited liability company (Rajagopal et al., 1999). Ownership of shares makes investors have claims on company income in the form of capital gains and dividends, claims on company assets, and the right to attend the General Meeting of Shareholders (GMS). The more shares owned, the greater the ownership rights of investors in the company. If the company develops, investors' capital will increase in investment value. Investors will get a profit (return), both from the distribution of dividends on company profits and capital gains from the increase in the company's stock price. This investment gain (return) is directly proportional to the investment risk (risk).

### b. Signaling Theory

Gonedes (1978) states that signaling motivation encourages management to carry out earnings management in presenting financial information, both in the form of an increase in profits and dividend levels, in the hope that it can signal prosperity to shareholders. Signaling motivation also

encourages management to withhold negative information within a certain time limit and obscure the true information through the presentation of financial reports or annual reports with low readability. High levels of earning opacity and low readability are negative signals for the market that can trigger stock price crash risk.

### c. Stock Price Crash Risk

*Stock price crash risk* is the drastic and sudden drop in stock prices that occurs when negative news about previously hidden issuers surfaced (Wen, 2016; Bleck & Liu, 2007; Jin & Myers, 2006). The measurement of stock price crash risk is based on firm-specific stock returns as measured by the residual model of the company's stock returns after the effects of changes in market returns and industrial returns are set aside, both at the time of observation, before, and afterwards (Wen, 2016; Bradshaw et al., 2010); and Hutton et al., 2009). Wen (2016) shows that stock price crash risk is also influenced by earning opacity.

### d. Earning Opacity

In reflecting on how little information there is in the value of a firm's earnings on the actual unobservable economic performance, as referring to Bhattacharya et al. (2003), earning opacity is a combination of earning aggressiveness, earning smoothing, and loss avoidance. Earning aggressiveness is the opposite of accounting conservatism - where economic losses are internalized more quickly, while economic gains are internalized more slowly in the company's profit / loss statement (Ball, Kothari & Robin, 2000).

According to Altamuro et al. (2005), earning aggressiveness is defined as a management action that leads to the tendency to delay the recognition of losses and accelerate earnings, which then has an impact on earnings quality. Earning aggressiveness is related to management actions to manipulate earnings (earning manipulation) (Bedard & Johnstone, 2004). Earning aggressiveness is carried out by increasing the value of accrual components, such as inventory, and simultaneously reducing costs, so that profits are higher than actual profits (Chan et al., 2001).

### e. CEO Overconfidence

*Overconfidence* (optimistic bias) is shown as a normal and systematic tendency for everyone to be overly optimistic about the results that will be received in the future, especially for those who have significant influence or control (Zhao & Ziebart, 2017; Armor & Taylor, 2002). In company management, the tendency of executives to be overconfidence can damage financial decisions. Recent research results show that in the case of a merger, the overconfident CEO actually paid more for the company that was the target of the merger and entered into a merger that damaged the company's value after the merger.

CEOs who are overly confident also tend to overestimate their own abilities, ignore competitors' abilities, and underestimate competitors' counter strategies. Likewise, overconfidence will lead to overinvestment, such as excess entry into the market, overpayments in acquisitions, and

imprudent or imprudent capacity expansion. In practice, the Board of Commissioners prefers to appoint a rational CEO rather than a CEO who is overly confident (Zhao & Ziebart, 2017). In their research on the effect of CEO overconfidence on the cost of debt in the credit market, Zhao & Ziebart (2017) show that the market discounts CEO overconfidence by increasing the cost of credit.

#### f. Financial Report Readability

*Readability*, in a business context, is the ability of individual investors and analysts to assimilate relevant information from the financial disclosures of a report for valuation purposes (Nguyen & Kimura, 2018; Loughran & McDonald, 2014). Readability in the MD&A (Management Discussion & Analysis) section of the financial report is important for investors to understand financial fundamentals and management performance. In the accounting literature, the measurement of financial report readability with the Gunning Fog Index has been widely used (Lo et al., 2017; Rennekamp, 2012; Lehavy et al., 2011; Miller, 2010).

However, because the Fog Index measures financial report readability based on the calculation of words per sentence and complex words in MD&A, the Fog Index has limitations in measuring financial report readability. Fog Index is limited to measuring readability as the grammatical quality of the content of financial information in MD&A, not the level of information relevance of a financial disclosure as intended by Nguyen & Kimura (2018) and Loughran & McDonald (2014).

#### g. Framework of thinking

Based on the description above, the conceptual framework in this study could disseminated as follows:

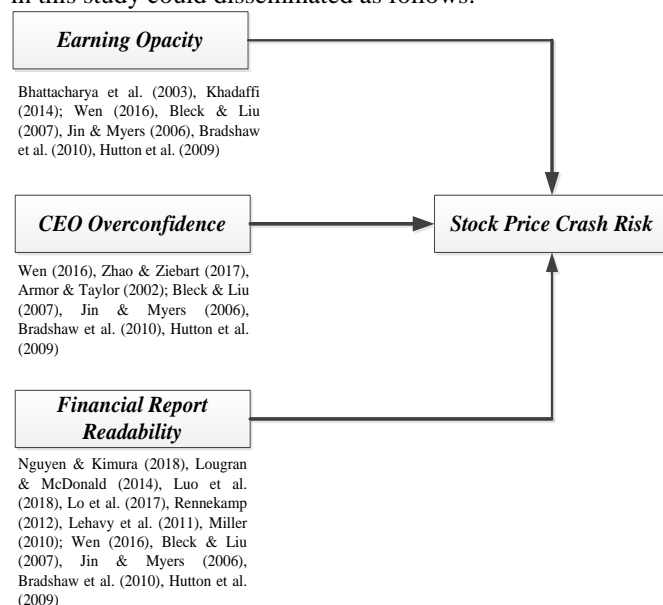


Figure 1 Conceptual Framework

### Research methods

Based on the objectives, this study uses a design explanatory research (hypothesis testing) with the causality approach

which aims to explain the causal relationship (influence) between variables through hypothesis testing (Sekaran & Bougie, 2017). The causal relationship described is influence *earning opacity*, CEO overconfidence and financial report readability to *stock price crash risk*.

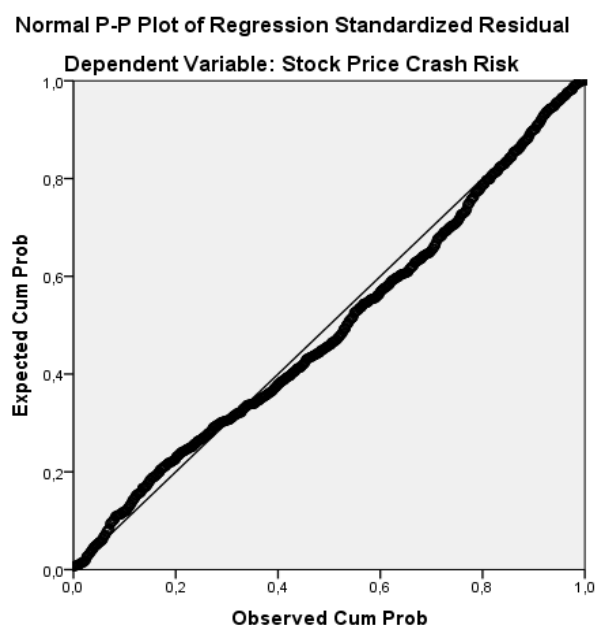
The unit of analysis in this study is an Indonesian manufacturing company listed on the IDX for the period 2014-2017 or the period after the 2013 economic crisis in Indonesia due to the pressure of the depreciation of the rupiah and rising inflation (Bank Indonesia, 2014: xxvii). The size of the target population in this study was as much 164 companies manufactures that go public on the IDX, which is divided into the basic industry and chemical sectors (71 companies), various industries (49 companies), and the consumer goods industry (44 companies) (Indonesia Stock Exchange, 2018). Based on the size of the target population, namely 164 manufacturing companies that went public on the IDX, according to the established sampling criteria, a sample size of 155 companies was obtained. The analysis technique used in this study is multiple linear regression analysis.

### Discussion

Based on the results of tests carried out using the statistical program tools SPSS 22, the results show that:

#### h. Normality test

The data normality test uses a normal probability plot curve provided that if the points on the graph are spread out and are squeezed around the diagonal line, the data used is normally distributed. The results of the normal probability plot data normality test are as follows (Ghozali, 2018):



Source: Results of Data Processing  
Figure 2 Normality Test

In the picture above, it is known that the data with the Normal PP Plot on the residual value of all variables used are stated to be normally distributed or close to normal. This is because the points in the distribution image appear to be

spreading or approaching around the diagonal line and the distribution of the data points is in the same direction by following the diagonal line.

i. Classic assumption test

1) Multicollinearity Test

Multicollinearity test is used to test whether or not there is a perfect linear relationship between some or all of the causal variables in the regression model. The requirement for the application of multiple regression models is that the causal variables do not have a perfect relationship or contain multicollinearity. The detection of multicollinearity is done by calculating the amount of Variance Inflation Factor ( $VIF = 1 / (1-R^2)$ ) or tolerance ( $1-R^2$ ) for each causal variable based on the coefficient of determination ( $R^2$ ) of the model for each causal variable explained by other causal variables. with the help of the SPSS program. If a causal variable has  $VIF \geq 10$  or tolerance  $\leq 0.1$ , then the causal variable has a multicollinearity problem with other causal variables. Meanwhile, if a causal variable has a  $VIF < 10$  or tolerance  $> 0.1$ , the causal variable does not have a multicollinearity problem (Ghozali, 2018). The results of the multicollinearity test in this study are presented as follows:

Table 1 Multicollinearity Test

Model	Unstandardized Coefficients		Collinearity Statistics	
	B	Std. Error	Tolerance	VIF
1(Constant)	1,754	,963		
Earning Opacity	,088	,239	,996	1,004
CEO Overconfidence	,012	,082	,995	1,005
Financial Report Rediability	,011	,011	,997	1,003

Source: Results of Data Processing

Based on table 1 it can be seen that the value *Tolerance* produced has met the specified limit, namely  $\leq 0.1$ , while most of the *VIF* values obtained have also met the specified limit, namely  $< 10$ . Therefore, it can be decided that all variables studied in this study are free from multicollinearity deviations.

2) Autocorrelation Test

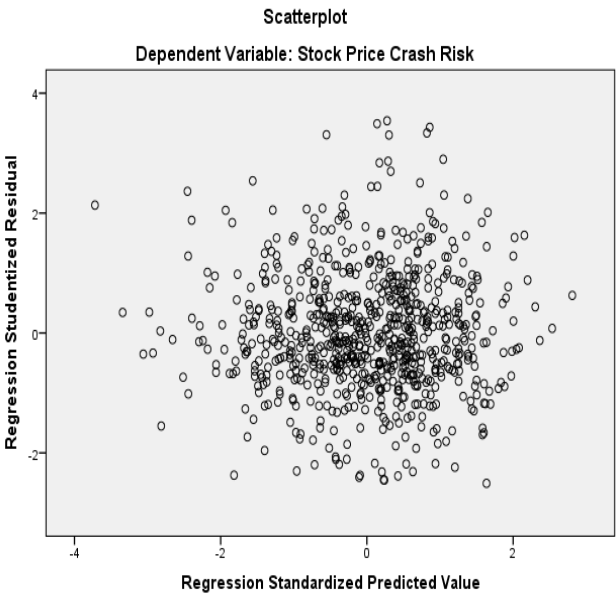
The autocorrelation test is related to the effect of observers or data in one variable that is related to one another. The value of a data can be influenced or related to other data (or previous data). The basis for the decision making of the Durbin-Watson test method (DW test) with the following conditions:

- a) If the durbin-watson value is less than dL or greater than (4- dL) then there is autocorrelation.
- b) If the durbin-watson value lies between dU and (4- dU), then there is no autocorrelation
- c) If the durbin-watson value lies between dL and dU or between (4- dU) and (4-dL), it does not produce a definite conclusion.

The dL and dU values in this study were obtained by looking at the Durbin-Watson table, where the dL value in this study was 1.6937, then the dU was 1.7747. Then the 4-dL value is 2.3063 and the 4-dU is 2.2253. Then the durbin watson (DW) value obtained from the test results is 2.159 located between dL and dU or the area does not produce definite conclusions. However, because the DW value is not located in the negative or positive autocorrelation area, it was decided that the data in this study were free from deviations from the autocorrelation assumption (Ghozali, 2018).

3) Heteroscedasticity Test

Heteroscedasticity is a condition in which the variance of the residual value is unequal between one observer (observation) and another observer. If the variance and residual value are equal between one observer and another observer, then this condition is called a homoscedasticity condition. A good regression is a regression that is in a homoscedasticity position and not a heteroscedasticity condition. The variable is stated in the position where there is no heteroscedasticity if the distribution of observer points above and or below zero on the Y axis leads to an unclear pattern. Based on the test results, the following data were obtained:



Source: Results of Data Processing  
Figure 3 Heteroscedasticity Test

j. R test

The coefficient of determination is a measure that shows the contribution of the explanatory variable to the response variable. In other words, the coefficient of determination shows the variance (variation) fluctuation of Y which is explained by the linear effect of X (how many parts of the diversity in variable Y can be explained by the various values of the variable X) (Ghozali, 2018). Based on the test results, the R value of determination is obtained as follows:



**Table 2 R Test**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,039a	,002	-,002	1,13850

Source: Results of Data Processing

Based on table 2, it can be seen that the R value of determination obtained in this study is 0.002 or 2%, this implies that the contribution of influence given by the three independent variables used in this research is very weak or only 2%. This means that there are still many variables not observed in this study that have the potential to affect stock price crash risk.

#### k. F test

The F-statistic test is used to test the effect of all independent variables simultaneously (simultaneously) on the dependent variable. The results of the F test in the study are as follows:

**Table 3 F-Statistics**

ANOVAa

Model	Sum of Squares	Df	Mean Square	F	Sig.
1 Regression	1,509	3	,503	,388	,762b
Residual	999,357	771	1,296		
Total	1000,866	774			

a. Dependent Variable: Stock Price Crash Risk

b. Predictors: (Constant), Financial Report Rediability, Earning Opacity, CEO Overconfidence

Source: Results of Data Processing

Table 3 shows that the calculated F value is 0.388 with a significance value of 0.762. Because the significance value is greater than the specified limit, namely 0.05 ( $0.762 > 0.05$ ), it can be concluded that together, the three independent variables in this study have no significant effect on *Stock Price Crash Risk*.

#### l. T test

The t test is used to test the regression coefficient partially from the independent variable. The test results on the t statistical value can be presented as follows:

**Table 4 t-Statistics**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1,754	,963		1,821	,069
Earning Opacity	,088	,239	,013	,369	,713
CEO Over Confidence	,012	,082	,005	,141	,888
Financial Report Rediability	-,011	,011	-,037	-1,022	,307

Source: Results of Data Processing

Based on table 4 it can be seen that the variable *Earning Opacity*, *CEO Over Confidence* and *Financial Report Rediability*, all of which have no significant effect on *Stock Price Crash Risk*. Meanwhile, when viewed from the direction of influence, *Earning Opacity* and *CEO Over confidence* has a positive direction of influence, while *Financial Report Rediability* has a negative direction of influence *Stock Price Crash Risk*.

Referring to the results of the statistical t test, it can be explained and translated as follows:

#### a) Influence Earning Opacity to Stock Price Crash Risk

Based on the results of the t test it is known that the t value of *Earning Opacity* amounted to 0.369 with a significance value of 0.713 ( $> 0.05$  = insignificant) and has a positive sign. This illustrates that the direction of the influence given is unidirectional, where if the *Earning Opacity* has increased, then *Stock Price Crash Risk* will also increase, and vice versa.

In signaling theory, the motivation for signaling encourages management to carry out earnings management, including earnings opacity in presenting financial information to signal prosperity (high profits and dividend rates) to shareholders (Gonedes, 1978). *Earning opacity* is a combination of earning aggressiveness, earning smoothing, and loss avoidance, which reflects how little information is available in the value of a company's earnings on actual unobservable economic performance (Bhattacharya et al., 2003). The high level of earning opacity will increase the stock price crash risk when negative news about issuers that were previously hidden emerges. The higher the level of earning opacity,

#### b) Influence CEO Over Confidence to Stock Price Crash Risk

Based on the results of the t test it is known that the t value of *CEO Over Confidence* amounted to 0.141 with a significance value of 0.888 ( $> 0.05$  = not significant) and has a positive sign. This illustrates that the direction of influence given is unidirectional, where if the *CEO Over Confidence* has increased, then *Stock Price Crash Risk* will also increase, and vice versa.

Increasing information about the management of public companies will reduce risks for investors and assist investors in setting prices (pricing) for their investments (Sengupta, 1998). The incentive motive of the CEO to achieve high company performance, in maximizing their own welfare (Jensen & Meckling, 1976), can encourage CEOs to overconfidence. The executive's tendency to be overconfidence can damage financial decisions (Zhao & Ziebart, 2017). CEOs who are overly confident tend to make decisions that damage company value, including over-investment, such as excess entry into the market, overpayments, and careless capacity expansion. or imprudent. High CEO overconfidence, which is marked by a profit prediction that is higher than the company's ability, will increase the stock price crash risk when negative news

about previously hidden issuers emerges. The higher the CEO overconfidence, the higher the stock price crash risk.

### c) Influence Financial Report Rediability to Stock Price Crash Risk

Based on the results of the t test it is known that the t value of *Financial Report Rediability* is equal to -1.022 with a significance value of 0.307 ( $> 0.05$  = insignificant) and has a negative sign. This illustrates that the direction of influence given is opposite, where if the Financial Report Rediability has increased, then *Stock Price Crash Risk* will experience a decrease, and vice versa.

In signaling theory, signaling motivation also encourages management to withhold negative information within a certain time limit and obscure the real information through the presentation of financial reports or annual reports with low readability (Gonedes, 1978). Readability is the ability of individual investors and analysts to assimilate relevant information from the financial disclosures of a report for valuation purposes (Nguyen & Kimura, 2018; Loughran & McDonald, 2014). Readability in financial reports is important for investors to understand financial fundamentals and management performance. The low level of financial report readability will increase the stock price crash risk when negative news about issuers that were previously hidden comes to the surface. The lower the financial report readability,

## Conclusion

Based on the test results, as well as the analysis of the results and discussion, the conclusions that can be drawn are:

1. Earning opacity positive effect on stock price crash risk
2. CEO over confidence positive effect on stock price crash risk
- Financial report rediability positive effect on stock price crash risk

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