

IMPACT OF ISLAMIC ETHICAL VALUE AND CURRENT EARNINGS ON THE READABILITY OF MUSLIM CHAIRMAN'S STATEMENTS

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ABSTRACT

The study tries to find the relationship between readability of chairman's statements with current earnings by distinguishing the religious background of the chairman. This study examines top 100 companies under Main Market in Bursa Malaysia in the year of 2010. The testing of relationship between readability of chairman's statements and current earnings follows the prediction of management obfuscation hypothesis (Courtis, 1998 and Li, 2008). Obfuscation hypothesis discusses on the management's practice to purposely make the annual report difficult to read by increasing the length (words per sentence, syllables per word etc) and increasing the usage of jargons in the writing (Sheikh Abu Bakar & Ameer, 2010) in order to hide the adverse current performance, suggesting that the readability is based on the management's ethic. Since Islam is premised on ethical and moral conduct (Mohd. Ibrahim & Yaya, 2005). It is hypothesised that the differentiation between chairman's religion should yield significant results.

Keywords: *Readability, manager obfuscation hypothesis, chairman's statement, Islamic ethical value*

Introduction

Agency costs exist due to the conflict between the agents and principals where the agents are acting not in accordance to the best interest of principals (Jensen & Meckling, 1976). In order to reduce the agency costs, Morris (1987) stated that there is a need to monitor the agents' activities and to bond the agents to the principals. One of the mediums used to monitor and to bond the agents to the principals is through periodic communications and reports. Therefore, annual reports have always been the main medium to reduce the agency costs between managers (agent) and shareholders (principal). It communicates the activities that have been conducted by the managers to the shareholders so that the shareholders can make informed decisions regarding their future investments. Annual reports not only consist of quantitative information but also narrative disclosure as a part of full communication package (Courtis, 1998). Since narrative disclosure acts as a part of full communication package, it is imperative for those who are responsible for writing the narrative to write the disclosure in an understanding manner so that the readers of the annual report will not misunderstand the information that they are trying to convey.

In a usual annual report, it consists of the chairman's statement, the corporate governance statement, the audit committee report and the financial statements (Lazar & Tan, 2004). Courtis (1998) stated that the chairman's statement or its equivalent is the most read section in the annual report. Therefore, the ease of understanding is an important feature of effective chairman's statement. Chairman's statement is an important part in an annual report even though it is a part of non-financial reporting and it is a collective view of the board of directors which includes a brief description of the industry trend and development, analysis of group performance, and the prospects of the listed issuer. In addition, the content of the chairman's statement is not governed by any statutory requirement or law and it is often written according to the chairman's styles and opinions. However, chairmen are able to exercise flexibility in both the writing style and the complexity of presentation. No matter what the presentation style is, the graphic used or the length of the statement, the company must be able to effectively communicate to the stakeholders about the performance of the company. This is important in order to ensure that the stakeholders can understand and interpret the same way as that is intended by the management.

However, previous studies have found that readability of annual report to be at difficult level (Courtis, 1995 & Smith, Jamil, Johari & Ahmad, 2006). In fact, Courtis (1995) states that here is no significant improvement in the annual report's readability over the course of five years. This suggests that annual report is not only difficult to read and to understand but also the company has made no effort to improve the reading-ease of the annual report. Furthermore, in a sample of UK manufacturing companies, Smith and Taffler (1992) find significant relationships between readability and profitability, liquidity and gearing ratios, which the strongest being the liquidity. Using Flesch and Lix readability formula, they found that poor readability is significantly associated with poor financial performance and ease of readability with good financial performance. Similarly, Subramanian, Insley and Blackwell (1993) find a positive relationship between readability and profitability where the annual reports of profitable companies are significantly easier to read than those of poor performers at the 0.0001 level of significance. It means, not only is the readability of the annual report is difficult but the management has purposely made the annual report difficult to read as an attempt to hide or obfuscate the adverse performance of the company. This is clearly an unethical behaviour conveyed by the management to fool the stakeholders.

This unethical behaviour is certainly against the Islamic ethic as Islam urges the pursuit of economic goals, but not at the expense of its moral obligations to society and to others affected by its actions (Beekun & Rafik, 2005). By purposely hiding the adverse performance through difficult to read annual report, the management is causing the stakeholders to make inaccurate judgements so that their own economic goals are well protected. In this paper, the management is referred to as chairman because based on our observation chairmen in Malaysia plays two roles, which are chairman and chief executive officers. In addition, some of the annual reports provide director's report instead of chairman's statement.

Our rationale for differentiating ethical behaviour through religion is because Grullon, Kanatas and Weston (2009) state that even though most religions may share the same elements of ethical codes, there are still distinctive differences between them, for example, how they conceive heaven and hell, salvation, God, and an after-life. Therefore, focusing on the chairman's statements only, we would like to see the impact of 1) current earnings (to

determine the extent of management obfuscation hypothesis), 2) chairman's religion and 3) Interaction between current earnings and chairman's religion to the readability of the statement.

Literature Review and Hypothesis Development

As we have stated before, the chairman's statement is the most read section in the annual report which provides stakeholders with overview of business operation, strategic planning of the companies, and companies performance from the view of the chairman. Being the means of communication for its stakeholders, the message provided in the chairman statements should be communicated effectively and comprehensively. Thus, readability is one of the techniques to be used for evaluating the effectiveness of communication in the chairman statement, where it is used as a tool of judgment of how easy a text is to Be understood.

Many studies have been done to investigate the readability index of the annual report. The general conclusion from previous studies is that annual reports are very difficult to read and may be classified as technical literature which risks being inaccessible to a large proportion of private lay shareholders, (Li, 2008).

Courtis (1986) uses Flesh and Fog readability formulas to measure 97 randomly selected chairman's address and footnote passages from the annual reports of some Canadian public companies for the year 1983 and finds that the report of 97 percent of the sampled companies are written at a level of difficulty equivalent to academic or scientific literature. In Bangladesh, by using the Flesh readability index, Hossain and Siddiquee (2008) find that majority of the management reviews, i.e. the chairman's letter and directors' report of some selected companies listed on the Dhaka Stock Exchange Ltd. are more difficult to read. Similarly, Sheikh Abu Bakar and Ameer (2010) found that the readability of Corporate Social Responsibility (CSR) communication (disclosure) for a sample of listed companies in Malaysia varies from very difficult to fairly difficult.

Sheikh Abu Bakar and Ameer (2010) also found that management of poorly performing companies deliberately choose difficult language in

CSR communication which supports the obfuscation hypothesis (i.e., good financial performance will be associated with clear and readable narratives, and that obscure and difficult narratives will be associated with poor financial performance.). The result corroborates the ideas of Li (2008) who suggested that firms with lower earnings tend to file annual reports that are more difficult to read. Courtis (1998) who termed 'obfuscation hypothesis' suggested that management is not neutral in its presentation of accounting narratives, when managers may want to strategically hide bad information through less transparent disclosure. Therefore the first hypothesis is as follows:

H1: There is a positive relationship between readability and current performance.

From the above discussion, it is clear that the 'obfuscation hypothesis' is unethical and immoral since the managers are trying to mislead the stakeholders through obscure and difficult narratives. Islam discourages this opportunistic behaviour since Islam is premised on ethical and moral conduct. According to Mohd Ibrahim and Yaya (2005), Islamic ethical and moral code of conduct permeates human life whether individual or collective in a way that Islam considers ethics as an offshoot of the Muslim belief system itself. Under Islamic business principles, all transactions, operation and services have to comply with Islamic rules, principles and codes of practices known as *Shariah*. The main objectives of *Shariah* are to promote social justice and welfare and set the foundations for moral, social, political and economic behaviour as stated in Quran and *Sunnah* (Haniffa & Hudaib, 2002).

Shariah has different objectives for accounting and reporting. Lewis (2001) noted that *Shariah* views accountability based on two main themes. The first is *Tawhid*, which implies total submission to God's will, and adherence to the religious requirements in all aspect of life. The second theme is the concept of ownership, where Islam recognises God as the ultimate owner of everything. This means everyone has the right to own property, but the ownership is not absolute. A person holds property in trust for God, and should use this property according to God's will. Thus, the main objective of accounting in Islam is to fulfil accountability to God.

The concept of disclosure is related to the concept of accountability. In Islam, a business should disclose the necessary information to advise the stakeholders about its operations, and the stakeholders have a right to know the effect of the business performance to them. As such, disclosing the truth is important in Islam. This is emphasis in the “Quran and cover not the truth with falsehood, nor conceal the truth when you know” (Quran, 2:24). Baydoun and Willet (1997) argued that everything that is believed to be important to Islamic users for the purpose of serving God should be disclosed. Therefore, in preparing chairman’s statement, Muslim chairman should adhere to Islamic ethical and moral code of conduct, where he should disclose in transparent manner without hiding behind lengthy sentences and complex jargons. This is in line with Quran (9:119), “O you who believe! Be afraid of Allah, and be with those who are true (in words and deeds)”. Thus, we infer that there is a relationship between the ethical religious value and readability, proxy for accountability. To determine whether Islamic ethical and moral code of conduct have an impact on the readability, we choose to distinguish the statement prepared between a Muslim and a non-Muslim chairman. With that, we have come out with the following hypothesis:

H2: There is a significant relationship between readability and chairman’s religion.

Accordingly, Muslim chairmen are expected to disclose all true information about their operations to the stakeholders, even if the information being disclosed is unfavourable. Furthermore, if the company does encounter poor performance issues, the manager should report truthfully, as per *Shariah* (Abdul Rahman et. al., 2010). Thus, there will be no obfuscation of bad or adverse performance. The Chairmen will not try to hide anything and will provide full disclosures relating to their performance. Since the Islamic teaching posited religion should not be separated from the business conduct, we add another hypothesis as follows :

H3: There is a significant relationship between readability and interaction between performance and chairman’s religion.

Methodology

Sample Selection and Source of Data

The sample of this study consists of 100 top companies under the Main Market of Bursa Malaysia in the year of 2011. The ranking is based on their score of market capitalisation, which is retrieved from Thomson Financial on 24th April 2012 based on market capitalisation daily on 5th December 2011. The focus of this study is on the chairman’s statements and its equivalent in the annual report. The statement is copied and pasted in Microsoft Word software and subsequently calculated for the readability index. The readability is measured only on the narration section. It means it excludes the graphs, tables, charts, pictures and other information presented in diagram form. Companies, whose chairman’s statements cannot be copied and contain missing values were excluded. Only 90 companies are left as the final sample.

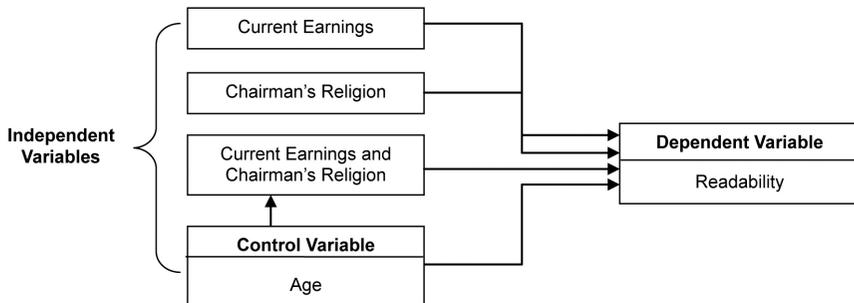


Figure 1: Theoretical Framework for Impact of Readability on Current Earnings, Chairman’s Religion and Interaction between Current Earning and Chairman’s Religion

Regression Model

The model is as follows:

$$\text{Readability} = \text{Current earnings} + \text{Dummy chairman's religion} + (\text{current earnings} \times \text{chairman's religion}) + \text{age} + \varepsilon$$

- Where: Readability = Flesch Reading Ease Index (FRE), length of text (LENGTH) and Flesch-Kincaid index (FK)
- Current earnings = Return on Assets (ROA)(Li, 2008)
- Dummy chairman's religion = Represents 1 for Muslim and 0 for non-Muslim
- Age = Number of years since a company being listed on Bursa Malaysia

This model uses readability as the dependent variable and tested the impact of mentioned independent variables on the readability. Readability in this study means quantitative measure of the ease of comprehension or understanding of written matter. Several readability formulas have been developed and for this study, we use 3 different variables to empirically measure the readability. The first variable is Microsoft Word's Flesch Reading Ease (FRE) Score that is based on a formula developed in 1949 by Rudolf Flesch. This readability index rates text on a 100-point scale based on the average number of syllables per word and words per sentence. Syllables per word are a measure of word difficulty. Words per sentence are an indicator of syntactic complexity (Stockmeyer, 2009). This formula was chosen because it is considered reliable, valid and practical, Schroeder and Gibson (2010). Further, as suggested by Sheikh Abu Bakar and Ameer (2010), since this formula is widely accepted and valid for assessing readability for adult materials, it is possible to compare the findings with previous studies. For validity purposes, we use another two variables for readability; Flesch Kincaid (FK) and length of document (LENGTH). This model is then regressed individually for the three readability proxies.

Table 1: Flesch Reading Ease Ratings (Courtis, 1995)

Reading ease Rating	Difficulty	Educational level	Typical magazine style
0-30	Very Difficult	Postgraduate	Scientific
30-50	Difficult	Undergraduate	Academic
50-60	Fairly difficult	Grade 10-12	Quality
60-70	Standard	Grade 8-9	Digest
70-80	Fairly easy	Grade 7	Slick fiction
80-90	Easy	Grade 6	Pulp fiction
90-100	Very easy	Grade 5	Comic

Table 1 shows the FRE ratings. It indicates that the higher the reading eases score, the easier is to understand the document. However, for the FK score, the readability ease ratings will work in an opposite way where the higher indicates less readable and the lower indicates more readable. As for the LENGTH, Li (2008) states that assuming everything else to be equal, longer documents seem to be more deterring and more difficult to read.

Results and Discussion

Descriptive Statistic

Table 2: Descriptive Statistic

	Mean	Std. Deviation	N
Variables			
FRE	27.4678	9.27904	90
LENGTH	3.2857	.28654	90
FK	14.6444	3.18473	90
ROA	.7841	.39470	90
DUMMYCReligion	.5778	.49668	90
AGE	19.1333	7.69532	90

Table 2 shows the descriptive result for readability (FRE, LENGTH and FK) as dependent variable separately. Independent variables consist of current performance as measured by return on assets (ROA), Muslim/non-Muslim chairman with Muslim chairman being 1 and non-Muslim chairman being 0 (DUMMYCReligion) and age of the company since being listed in Bursa Malaysia until 2010 (AGE).

Table 2 shows the descriptive statistic for the variables. The mean for in Flesch Reading Ease (FRE) is 27.47, indicating that the chairman’s statement is very difficult to read. This concurs with the mean Flesch-Kincaid (FK) of 14.64 and Length of the text (LENGTH) of 3.29, in which both show difficult reading. These readability scores are consistent with the findings of previous studies (Courtis, 1986; Hossein & Siddiquee, 2008; Feng, 2008 Sheikh Abu Bakar & Ameer, 2010) where they have also found readability of the annual report to be difficult.

Breaking down the figures, we found 62% of the companies’ chairman’s statements are very difficult to read. Only 36% of the companies classified as difficult and 2%, which represents only one company, is classified as fairly

difficult. This shows that the language used in the chairman’s statements in Malaysia are difficult to be understood by diversified readership. Our findings clearly support the findings of Sheikh Abu Bakar and Ameer (2010), when they find 79.3% of the corporate social responsibility disclosure in Malaysia being classified as very difficult. All of the variables have been tested for normality.

Multivariate Regression Analysis

Previously, we have posited three hypotheses. Firstly, we hypothesise that there is a positive relationship between readability and current performance. We have hypothesised that if the company is doing poorly in the current year, the company will try to hide the adverse performance through deliberate difficult reading. This is in accordance to the management obfuscation hypothesis.

We also put forward the second hypothesis, stating that if the chairman is Muslim, it will give further impact on the readability level. If beta coefficient shows positive relationship for proxy FRE and negative for proxy LENGTH and FK, Islamic ethical value and moral code of conduct will give a positive impact on the chairman’s statement readability. However, the result shows otherwise or negative relationship, it means that Islamic ethical values give negative impact on the readability. This result is only applicable for FRE because the other two proxies will give an opposite result compared to FRE. For FK and LENGTH, the expected beta coefficient will be *vice-versa*.

For the last hypothesis, we include the interaction of chairman’s religion and current performance and regress it on the readability proxies. This is to test whether the management obfuscation hypothesis can be negated by Islamic ethical value.

Table 3: Regression Analysis

Flesch Reading Ease (FRE) Index				
Variables	Unstandardized Beta	Standardized Beta	t	Significant
(Constant)	20.443		4.562	1.000***
ROA	7.940	0.338	2.281	1.025**

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IMPACT OF ISLAMIC ETHICAL VALUE AND CURRENT EARNINGS ON THE READABILITY

CReligion	11.247	0.602	2.575	0.012**
AGE	-0.102	-0.084	-0.771	0.443
ROA*CReligion	-9.006	-0.438	-1.811	0.074*
R	0.327			
Adjusted R-square	0.065			
F-value	2.538**			
Length Index				
Variables	Unstandardized Beta	Standardized Beta	t	Significant
(Constant)	3.557		25.976	0.000***
ROA	-0.314	-0.433	-2.955	0.004***
CReligion	-0.148	-0.256	-1.107	0.271
AGE	0.000	0.012	0.108	0.914
ROA*CReligion	0.126	0.199	0.830	0.409
R	0.354			
Adjusted R-square	0.084			
F-value	3.041**			
Flesch-Kincaid (FK) Index				
Variables	Unstandardized Beta	Standardized Beta	t	Significant
(Constant)	17.422		11.335	0.000***
ROA	-1.857	-0.230	-1.555	0.062*
CReligion	-3.663	-0.571	-2.445	0.017**
AGE	-0.005	-0.012	-0.111	0.912
ROA*CReligion	2.138	0.303	1.253	0.214
R	0.328			
Adjusted R-square	0.066			
F-value	2.566**			

Table 3 shows the regression result readability (FRE, LENGTH and FK) as dependent variable separately. Independent variables consist of current performance as measured by return on assets (ROA), Muslim/non-Muslim chairman with Muslim chairman being 1 and non-Muslim chairman being 0 (DUMMYCReligion), age of the company since being listed in Bursa Malaysia until 2010 (AGE) and interaction variable of current performance and chairman's religion (ROA*CReligion).

*** Significant at 1%

** Significant at 5%

* Significant at 10%

From Table 3 we can see that for FRE, the readability of chairman's statement is positively related with current earnings. This is further supported by the negative relationship between FK/LENGTH with current earnings. We can see significant results using all proxies for readability. It means that when the company's performance is undesirable, the readability of the chairman's statement becomes significantly more difficult. This concurs with management obfuscation hypothesis and thus, hypothesis 1 is supported.

When we analyse the beta coefficient of chairman's religion variable to see whether Islamic ethical value and moral code of conduct give further impact on the chairman's statement readability, we found that chairman's religion variable's beta coefficient is positive (negative) for FRE (LENGTH and FK) and this is in line with our second hypothesis. The result shows that there is a significant relationship between religion and readability and this supports our second hypothesis. It means that Muslim chairmen adhere to the Islamic ethical value in discharging their accountability by disclosing the company's performance in a manner that is understandable by their stakeholders. This can be seen through significant result for FRE and FK proxies, which is significant at 5%.

Table 4: Independent T-test Group Statistic

	N	Flesch Reading Ease (FRE)	Log of Length (LENGTH)	Flesch-Kincaid (FK)
Muslim chairman	52	29.09	13.87	3.28
Non-Muslim chairman	38	25.24	15.70	3.29

Table 4 shows the independent t-test of readability measurement for FRE, LENGTH and FK between Muslim chairman and non-Muslim chairman.

Table 5: Levene's Test for Equality of Variance

	F-value	Sig (2-tailed)
Flesch Reading Ease	0.008	0.052**
Log of Length	4.913	0.006***
Flesch-Kincaid	0.042	0.855

Table 5 shows the independent t-test of readability measurement for FRE, LENGTH and FK between 1) Shariah and non-Shariah compliant companies and 2) Muslim chairman and non-Muslim chairman.

*** Significant at 1%

** Significant at 5%

We further test readability between Muslim and non-Muslim chairman to see whether readability for Muslim chairman's statement is easier than non-Muslim statement. As Table 4 and 5 indicate, the readability of Muslim chairman is significantly easier as indicated by higher FRE and lower LENGTH; both are significant at 5% and 1% respectively. It suggests that chairman's statement that is written by Muslim chairman is statistically easier and more understandable compared to non-Muslim chairman. This result further supports hypothesis 2.

What is most interesting is that, when we include current performance and chairman's religion (ROA*CReligion) interaction as part of regression model, we can see that it does give significant impact on the chairman's statement readability when the company's performance is undesirable. The result is significant at 10% for proxy FRE. It seems that there is a significant relationship between readability and the interaction between current performance and chairman's religion, which supported our third hypothesis. The negative result implies that when a company experiences adverse performance, the readability of the Muslim chairman's statement is significantly more difficult compared to when the company's performance is favourable. It suggests that when a Muslim chairman has to report undesirable performance, he succumbs to the pressure of the need to portray good performance despite actual bad performance and he tends to obfuscate the information through difficult reading.

This result suggests that Islamic ethical and moral code of conduct is present only when there is no motivation to hide any adverse performance. But when the Muslim chairman faces the choice between portraying the untrue performance and disclosing the true picture, he chooses the alternative that is to cover the company's reputation even though he might mislead the company's stakeholders. However, it does not mean that Islamic values are at fault. It may be due to the behavioural factor of the individual chairman that leads to unethical choices made by them. Islam is wholly and constant but it is the internalisation process by each of devotee that differentiates one Muslim to another. This is further agreed by Ahmad Munawar et al. (2011), who explains that according to Imam al-Ghazali, human actions and deeds reflect the way he thinks and the knowledge he has. Subsequently, his acceptance towards knowledge depends on his ability to balance the surrounding temptations by utilising aqidah and iman. In other words, the

same knowledge can be absorbed or internalised differently by different people, depending on his surroundings.

Conclusion

The aim of this study is to determine the relationship between readability of chairman's statements with current earnings by distinguishing religious background of the chairman. By using the 100 top companies in Malaysia, we find that there is a significant, at 1% (Length), 5% (FRE), and 10% (FK), relationship between the chairman's statement readability and the chairman's religion.

However, this study only focuses on a sample of 100 top companies. For future research, it is recommended to include larger sample which represents the whole population of the market that might produce more interesting results. We also would suggest the inclusion of identification of jargons in measuring the readability index since chairmen's statements are written by chairmen who have strong accounting and business background. By including the identification of jargons, the measurements of readability will be more accurate.

The management obfuscation hypothesis posits that management will deliberately obfuscate the adverse current performance through difficult writing styles. Without ethical principles, management would surely abuse the trust given by the stakeholders. We argue that based on Islamic ethical value and moral code of conduct, the Muslim chairman should disclose the information truthfully regardless of the company's performance. Our study finds that in the event the company is doing well, the readability of the Muslim chairman's statement is easier compared to non-Muslim chairman statement. However, when the company faces adverse performance, the Muslim chairmen tend to obfuscate current performance through difficult reading as well. The finding of this study contribute to the existing Islamic ethics literature in the context of Islamic accountability.

Our study does not, however, mean that the Islamic teaching contributes to the unethical action of dishonest disclosure. As Muslim, Islam is not just a devoted religion. It has to come together with good and ethical deeds, as

being taught to its devotees. Any unethical action taken by individuals is the result of the individual's level of accepting Islamic knowledge (Ahmad Munawar et al., 2011). If he is unable to balance the temptation of doing wrongful deeds, his acceptance of Islamic knowledge is flawed and it will be portrayed through his unethical actions. Thus, it can be said that the Muslims unethical conducts may be due to particular surroundings faced by them and the behavioural factors that are embedded in their own selves. However, being a true Muslim, believing and acknowledging in the presence of the hereafter; heaven and hell, may Insha'Allah help us in leading our entire life as per Allah's order.

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