



# QUARTERLY REPORTING

Is Less More, or is More More?



BY  
DR TAN BOON SENG, MIAO BIN & LIM AI LEEN

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he frequency that listed firms should report their interim financial results has been hotly debated recently, with three articles on this topic published in *The Business Times* from 27 January to 12 February 2014. In principle, modern information technology used

in accounting allows companies to prepare monthly or even daily reports to support operational management, and it is believed that with some effort, these reports can be modified for interim financial reporting. The International Accounting Standard No. 34 (IAS 34) on Interim Financial Reporting provides guidance on the content and principles of preparing these interim reports, but leaves the decision of the specific interval to “national governments, ... and accountancy bodies” (IAS 34.1). In practice, the debated choice of reporting frequency is between quarterly reporting (QR) and semi-annual reporting (SR).

In Singapore, QR was partially introduced in 2003 – listed firms with market capitalisation above \$75 million require QR while those with lower market capitalisation require SR. The Ministry of Finance reviewed the arrangement in 2006 and retained the arrangement. In addition to the reporting of interim financial results by these larger listed firms, the Singapore Exchange (SGX) specifies under its Rulebook in Appendix 7.1 (Corporate Disclosure Policy) the major scenarios

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where an announcement is required<sup>1</sup> to comply with Rule 703 (Disclosure of Material Information). In this article, we review the reporting practice in major capital markets and evaluate the arguments of the debate in light of recent research findings.

## 1 SNAPSHOT OF INTERIM FINANCIAL REPORTING PRACTICES IN MAJOR CAPITAL MARKETS OUTSIDE SINGAPORE

The US has the longest history of QR. In 1955, the Security Exchange Commission (SEC) mandated the reporting of semi-annual Income Statement; this was changed to a quarterly basis in 1962. Beginning in 1970, QR has been required for the full set of condensed financial statements in the US. Canada followed the QR practice in 1972, Malaysia in 1999, China in 2003 and Japan in 2008. The usual arguments for QR are the timeliness of information so that equity price better reflects the value of the firm, and that it enhances accountability and corporate governance.

Hong Kong consulted on moving towards QR to be in line with China in 2008, but was unsuccessful. Hong Kong currently requires SR for mainboard-listed firms but QR for Growth Enterprise Market (GEM) firms. In the GEM case, the Q1 and Q3 reports

are less detailed than the Q2 and Q4 reports. As the listing requirement in GEM is less onerous for profitability and track record than for those on the main board, the rationale for more frequent disclosure is linked to the higher risk inherent in GEM firms. In contrast, the Alternative Investment Market (AIM) of the London Stock Exchange (UK) – similar to Hong Kong's GEM – does not require QR. The TechMark of the London Stock Exchange, which specialises in technology firms, requires QR. The mainboard-listed firms in the UK adopted SR in 1997, and listed firms in Australia have adopted SR since the early 1970s by securities law (and formally in 1994 by the Australian Accounting Standards Board Statement No. 1029). Jurisdictions with SR always allow firms to voluntarily practise QR.

The European Union (EU) arrangement is a complicated story. EU was trying to harmonise its interim financial reporting with the introduction of the Transparency Directive (TD) in 2004 and mandating QR in accordance with IAS 34. Due to opposition from four member states – the UK, Netherlands, Denmark and Austria – the IAS 34 requirement was substituted with non-financial Interim Management Statements (IMS). Subsequently, IMS was criticised for being too flexible and there were calls



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for modernisation. The outcome is surprising – EU will abolish mandatory QR, whether by IMS or IAS 34, by 2015.

Our brief review of the practices in major capital markets suggests that the choice of reporting frequency is influenced by both the traditional economic cost-benefit considerations and each individual jurisdiction's own political processes. While the political concerns are largely country-specific, the cost-benefits analysis is rooted in generic economic theories and therefore has broad implications for policymakers from all over the world.

In the next few sections, we discuss the costs and benefits of QR from the perspectives of different stakeholders



in light of recent findings from academic accounting literature. Our goal is to present a balanced view of the key arguments, and objectively evaluate their merits in the context of Singapore's own institutional background.

## 2 INVESTOR'S PERSPECTIVE

The fundamental value of financial reporting lies in the fact that it reduces the information asymmetry between company insiders and external

<sup>1</sup> [http://rulebook.sgx.com/en/display/display\\_main.html?rbid=3271&element\\_id=5372](http://rulebook.sgx.com/en/display/display_main.html?rbid=3271&element_id=5372)

<sup>2</sup> For more detailed discussion about the specific accounting areas where errors are likely to occur in quarterly reporting, see Mensah, Y. and Werner, R. (2008) "The Capital Market Implications of the Frequency of Interim Financial Reporting: An International Analysis", *Review of Quantitative Finance and Accounting*, Volume 31(1): 71-104

investors. In a well-functioning capital market, the narrowed information gap means more information about the firm's underlying profitability is incorporated into share prices. In economists' jargon, this is termed "higher price informativeness". More informative prices benefit not just the participants of the market, but also the entire economy because capital will be allocated more efficiently to generate more outputs from the same amount of investment.

From the perspective of price informativeness, QR is generally considered as more desirable than SR because it brings more timely updates about the company's operations to investors. An important caveat to note, however, is that the accounting information in quarterly reports usually contains more noise than semi-annual or annual reports, especially when QR is prepared on the "discrete

basis". The noise could arise from many areas, such as estimation errors in accounting accruals and arbitrarily allocated period costs.<sup>2</sup> The increased noise level will reduce the usefulness of information in QR, especially for less sophisticated investors who do not have the required knowledge to separate noise from signal.

To illustrate this idea more clearly, suppose a firm introduces a new product that will generate total incremental contribution margin of \$8 million excluding advertising cost for the current year. The product requires advertising support of \$3 million in the first quarter of the year, and \$1 million for each quarter thereafter. In this example, the annual financials will show increase in earnings of \$2 million for the current year, which accurately reflects the total profitability of the product. In contrast, QR will first show a decrease of quarterly earnings of

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\$1 million followed by an increase of \$1 million each quarter thereafter. In other words, QR will introduce measurement fluctuation in each of the four quarterly reports, but the measurement fluctuations cancel out in aggregation.

If the investors are sophisticated users of financial accounting information, they will understand that the loss in Q1 is caused by the accounting rule that requires immediate expensing of advertising expenditure. As a result, they will not be deterred by the temporary loss when Q1 results are released, and bid up the share price of the company to reflect the total profit of \$2 million for the product. QR will therefore improve the informativeness of the share price by bringing the news about the new product earlier to the market. On the other hand, if the investors do not understand the accounting rule and naively fixate on the reported loss, then the share price will drop in response to the Q1 results and the company's share will be temporarily undervalued because of the noisy information in QR.

It can be seen from our discussion above that from the information perspective alone, the debate about the costs and benefits of QR is essentially the same as weighing the trade-off between relevance and reliability that we commonly encounter in the financial accounting standard-setting process. QR provides information that is more timely and hence more relevant for investors to make decisions, but at the same time, it sacrifices some reliability due to increased measurement fluctuation (more noise) for the shortened reporting period. On a net basis, whether QR provides useful information depends on market-specific factors such as investor composition, and is therefore likely to vary from country to country. However, a large volume of empirical research finds that investors from most major stock markets in the world react to quarterly accounting information. The evidence suggests high usage of QR information by investors.



### 3 PREPARER'S PERSPECTIVE

Traditionally, the out-of-pocket costs incurred for preparing interim financial reports are often cited as a reason against QR. With the development of technology, such cost has been drastically reduced and is no longer a major concern for large companies. For small and medium-sized companies though, these costs could still be too significant to ignore.

Compared to the tangible costs of preparing reports, the real cost of QR to the company and its shareholders may come from the manager's myopic behaviour in response to the price pressure caused by frequent interim reporting. To see this point, consider

a manager who has two alternative investment projects to choose from. The first project, A, is a long-term investment whose payoff will only be certain in five years, but will generate total NPV on a risk-adjusted basis of \$100 million.

The second project, B, is a short-term investment that will generate total NPV of \$10 million immediately in the next quarter. Suppose a significant proportion of the company's investors are short-term-oriented and focus on

<sup>3</sup> Givler, F., Kanodia, C., Sapp, H. and Venugopalan, R. (2014). "How Frequent Financial Reporting Can Cause Managerial Short-Termism: An Analysis of the Costs and Benefits of Increasing Reporting Frequency", *Journal of Accounting Research*, In Press

<sup>4</sup> Fu, R., Kraft, A. & Zhang, H. (2012) "Financial Reporting Frequency, Information Asymmetry, and the Cost of Equity", *Journal of Accounting and Economics*, Volume 54 (2-3): 132 - 149



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quarterly results. Then if the manager's compensation is tied to short-term share price performance, he will choose project B to report profit in the next quarter and forgo project A. This short-termism is clearly detrimental to the company's long-term value. Gigler et al. (2014)<sup>3</sup> studied this problem using an analytical modelling approach, and their results showed that lowering the frequency of financial reporting will help mitigate the manager's short-termism problem.

Putting the costs aside, QR can also bring significant benefits to the company through lowering its cost of equity capital. The mechanism through which QR works its magic is again by

reducing the information asymmetry faced by external investors. When investors are better informed about the company, they require lower return for holding the company's shares because they perceive the investment as being less risky. As a result, the company will be able to sell its shares at a higher price when they raise funds from the stock market, paying effectively lower cost of equity. Fu et al. (2012)<sup>4</sup> examined a sample of US companies from 1951 to 1973, a transition period during which companies in the US were required to switch from SR to QR. They found empirical evidence supporting the argument that QR reduces information asymmetry and lowers firms' cost of equity.

#### **4 SO, WHAT NOW?**

Quantity and quality of information are both important considerations for the choice of optimal financial reporting frequency. QR provides more timely information to investors, which is useful for them to assess the performance and financial strength of the company. On the other hand, quarterly accounting information usually contains larger amounts of measurement fluctuation, which is likely to reduce its usefulness, especially to less sophisticated investors. The debate can be framed as the trade-off between relevance (more timely) and reliability (less

noisy) of information, and the net outcome can only be evaluated by studying real investors' behaviour. The fact that share prices react significantly to quarterly earnings announcements suggest equity investors on average use QR information in their investment decisions.

In addition to its information value, QR can also benefit the company and its existing shareholders by lowering the cost of raising equity capital. But it may also encourage myopic behaviour from managers, especially when the company's shareholder base is dominated by impatient investors with short investment horizons. Such myopic behaviour includes underinvestment, suboptimal risk-taking and even earnings management, and is detrimental to firm value.

While the theories about QR can find applications in cross-country settings, the empirical evidence we reviewed in this article is mainly US-based. The optimal choice of reporting frequency is ultimately determined by specific characteristics of each individual capital market. For this reason, additional empirical research is needed to inform the QR policy in Singapore. ISCA

Dr Tan Boon Seng is Assistant Director and Miao Bin is Director, Technical Research, ISCA; Lim Ai Leen is Executive Director, Technical Knowledge Centre and Quality Assurance, ISCA.