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Events after Reporting Period and Misstatements in Quarterly Accounts

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ABSTRACT

The occurrence of deviation between annual and cumulative quarterly accounts has been postulated as a signal of low reliability in quarterly accounts. This study examines whether the earnings deviation is more related to misstatements rather than the occurrence of events after reporting period. Data is based on Bursa Malaysia listed companies consisting of 731 observations for the period of between 2000 until 2012. Only a total of 14% had declared events after reporting period, while 95% have declared misstatements as reasons for earnings deviation. Results of the t-test show that the magnitude of earnings deviation related to misstatements is significantly higher than those related to events after reporting period. The results suggest that earnings deviation is more related to low quality of quarterly earnings, instead of mandatory accounting adjustments. Finding suggests the need for the company and regulators to take actions to enhance the quality of quarterly accounts.

Keywords: Events after Reporting Period, Misstatements, Quarterly Accounts
JEL Classifications: M41, M42, M48

1. INTRODUCTION

Many countries have mandatorily required listed companies to issue financial accounts on quarterly basis, in addition to the traditional audited annual accounts. Malaysia, Pakistan, Singapore, Thailand and the US are among the countries which have made such requirements. The purpose is to allow a more timely dissemination of accounting information which then enhances the relevance of information contained in the accounts (Lightstone et al., 2012). Despite the benefits of timely information, many have questioned the reliability of quarterly accounts and evidence also indicates that there are many instances where information provided in quarterly accounts may not be accurate (Bedard and Courteau, 2015; Kinney and Trezevant, 1997; Lightstone et al., 2012).

In Malaysia, Bursa Malaysia had required all listed companies to produce quarterly accounts starting for the quarters ending 31st July 1999. This requirement was imposed as a response to the Asian Financial Crisis in 1997/1998 (Ismail and Abdullah, 2009) to replace the half-yearly reporting which was introduced in 1987 (Ismail and Chandler, 2005). Currently, the requirement is regulated under Chapter 9.22 of the Listing Requirements of Bursa Malaysia, where listed companies are required to produce their quarterly accounts no later than 2 months after the end of each quarter. Meanwhile, the annual audited accounts are required to be issued within four months from the close of financial year. However, as compared to annual accounts, the quarterly accounts are not mandatorily required to be audited, not only in Malaysia but also in other jurisdictions.

Earlier studies by Al-Darasyeh and Brown (1992) and Ibrahim et al. (2009) have argued that the occurrence of earnings deviation between the quarterly (cumulative) and annual (audited) accounts indicates that the quarterly accounts are less reliable. By using a sample of 261 listed companies in Bursa Malaysia for the year 2004, Ibrahim et al. (2009) reported that 64% of sample companies in Bursa Malaysia for the year 2004 have earnings deviation between both accounts. Furthermore, 52% of sample companies with earnings deviation have higher cumulative quarterly earnings than audited annual earnings. Meanwhile, using a sample of 190 of U.S listed companies between 1982 and 1987, Al-Darasyeh and Brown (1992) found significantly higher income reported in quarterly accounts than the annual accounts. Both studies argued that the occurrence of earnings deviation represents low quality quarterly accounts. The concern by the regulators has led to mandatory explanation of the deviation. In Malaysia, the Bursa Malaysia has required immediate mandatory explanation for companies with 10% and more deviation between earnings in cumulative quarterly accounts and audited annual accounts. In the U.S, a corporation is required to reconcile the difference between quarterly data in audited annual accounts (Form 10-K) to the earlier quarterly accounts released in Form 10-Q and to provide explanations on the difference (Kinney and McDaniel, 1989).

However, besides misstatements, earnings deviation can also be resulted from events after reporting period. In the case of Malaysia, 2 months lapse between the production of fourth quarterly accounts and the audited annual accounts exposes the accounts to the occurrence of events after reporting period of quarterly accounts, which may require adjustments. The adjustments to reflect the occurrence of these events are compulsory accounting treatment which cannot be related to low quality quarterly accounts. This mandatory adjustment has not been recognized in the studies by Al-Darasyeh and Brown (1992) and Ibrahim et al. (2009). This study extends both studies by focusing on whether the earnings deviation is more related to misstatements, rather than the occurrence of events after reporting period of quarterly accounts. It adds to the growing literature on quarterly accounts quality and enhances the understanding of quarterly earnings deviation.

2. LITERATURE REVIEW

Shareholders usually have minimal involvement in the management of the modern corporate structure and therefore, have limited information on corporate activities. Financial reporting is a main mechanism for managers to disseminate the asymmetry information to external users (Whittington, 1993). Even though, information can also be obtained from other sources, financial reporting provides the most comprehensive and reliable source of financial information. Financial accounts provide a common ground for investors to compare within firms or across time periods (Hodge, 2001). Therefore, it is crucial for the users to have quality reporting to ensure fair judgments. However, the heavy reliance placed on accounting numbers creates a strong incentive for managers to manipulate financial accounts whether for their own personal advantage or to cover-up their wrong doings (Rahman and Ali, 2006).

The traditional financial report for external reporting is prepared on an annual basis, but it suffers from timely problem, whereby some of the information provided in the reports may have become irrelevant at the time of production. Hence, interim reporting is favored to overcome this timely problem. Quarterly accounts are one type of interim reporting, besides the half-yearly accounts. It can be observed that the current trend around the world is to replace half-yearly reporting to quarterly reporting. The quarterly accounts which are prepared for a period of three months allows for a more timely dissemination of information and thus, allows for more regular monitoring by the interested parties. Timely reporting enhances the relevance of information contained in the accounts (Lightstone et al., 2012). Many have indicated the use of quarterly accounts by investors in their investment decision-making. Studies by Kiger (1972), Kross and Schroeder (1984) and Lee and Park (2000) which was conducted in the U.S while, a study by Ismail and Rahman (2012) conducted in Malaysia have all shown such evidence. Thus, it is important for companies to provide quality quarterly accounts. However, evidence indicates that there are many instances where the information provided in quarterly accounts may not be accurate. For example, Lightstone et al. (2012) reported that volatility of net income in each of the first three quarters is lower than in the fourth quarter, which the study argued for earnings management in the earlier quarters. Meanwhile, Kinney and Trezevant (1997), Ismail and Chandler (2005) and Ismail and Abdullah (2009) have all found the tendency of companies to defer the exceptional items to the fourth quarter reporting. As a result, the issue of the reliability of quarterly accounts has been raised. As highlighted by Lightstone et al. (2012): "While interim reports increase the relevance of the financial statements through more timely communication of position and results, their usefulness to users is also a function of their reliability (p. 298)."

Concern on reliability of quarterly accounts mainly has been related to the fact that the accounts are not required to be audited by an external auditor in most jurisdictions. While the financial accounts are prepared by the management, auditing enhances the credibility of the accounts, whereby the users have reasonable assurance that the financial accounts do not contain material misstatements or omissions (Bedard and Courteau, 2015). Unaudited quarterly accounts expose the accounts to the risk of errors and manipulations by the managers (Ismail and Chandler, 2005). Without auditing, the reliability of quarterly accounts is dependent on the management. As noted by Rahman and Ismail (2012), even though quarterly accounts contain relevant information, investors may take a longer time to incorporate the information due to the concerns on reliability of information provided. Empirical evidence by earlier studies have also indicated for the need of auditors' involvement. Pany and Smith (1982) found increasing reliability of quarterly accounts by financial analysts with the increasing auditor association. Manry et al. (2003) had found that the fourth quarter account which is subjected to limited audit review has a higher association of between earnings and equity market returns. Malaysia and Singapore are among the countries which do not require for auditors' involvement in quarterly accounts, while in Pakistan, the U.S and Thailand, only limited audit review is required.

Due to the lack of auditors' involvement and only annual accounts will be audited, the issue of fourth quarter settling-up in the preparation of quarterly accounts have been raised by researchers. It is argued that the fourth quarter accounts are used to reverse out the misstatements in the earlier three quarters' accounts (Ismail and Chandler, 2005: Ismail and Abdullah, 2009). Conceptually, researchers have also argued that a company may intentionally misstate the earlier three quarterly accounts and then, make adjustments or corrections in the fourth quarter accounts to avoid the deviation between the cumulative quarterly accounts and annual accounts. Collins et al. (1984) claimed that companies generally do not publish the fourth quarter accounts *per se*, but simply the difference between the annual and the cumulative of the first three quarters' accounts. The study had also found higher forecast errors in fourth quarter accounts than other quarters. In addition, the evidence by Kinney and Trezevant (1997), Ismail and Chandler (2005) and Ismail and Abdullah (2009) of the deferment of exceptional items from earlier to fourth quarter can also be viewed as a settling-up practiced by the management.

3. HYPOTHESIS

Accounting, itself involves alternative methods of application and estimations which can be manipulated by the management in presenting their desired numbers. At the same time, problem in the financial reporting process such as human errors also can result in low quality accounting. In addition, accounting requires management's judgments in dealing with some of the events. The basic idea of the preparation of quarterly accounts is that, the cumulative quarterly earnings should be similar to the audited annual earnings (Al-Darasyeh and Brown, 1992; Ibrahim et al., 2009; Ismail and Abdullah, 2009). This is based on the fact that the accounting policies and estimation methods applied in quarterly accounts are required to be consistent with those adopted for the annual accounts. Therefore, Al-Darasyeh and Brown (1992) and Ibrahim et al. (2009) have argued that the occurrence of earnings deviation between the two accounts indicates that the earnings reported in the quarterly accounts is an evidence of low quality quarterly accounts; where higher earnings reported in cumulative quarterly accounts than audited annual accounts represents overstatements of quarterly earnings, while lower earnings reported in cumulative quarterly accounts than audited annual accounts represents understatements of quarterly earnings. Their argument is based on the fact that the annual accounts which are audited by external auditors are regarded as having higher quality than quarterly accounts which are not audited. However, besides misstatements, earnings deviation can also be a result of the occurrence of events after reporting period, which may require adjustment in these accounts. The two months lapse between the production of fourth quarterly accounts and the audited annual accounts exposes the accounts to events after reporting period which may require for accounting adjustments. The adjustments to reflect the occurrence of these events would also result in the occurrence of earnings deviation. However, this compulsory accounting treatment cannot be related to low quality quarterly accounts as compared to other types of adjustments.

4. RESEARCH METHODOLOGIES

Data is based on listed companies on Bursa Malaysia between years 2000 and 2012. Table 1 presents the sample selection process. As at 31st December for each year, a total of 12,291 companies are observed. About 121 companies without quarterly or annual accounts, 18 companies producing accounts in non-Ringgit Malaysia currency, 499 newly listed companies, 265 companies with financial period of more or <12-month period and 535 companies which have audited quarterly accounts are excluded, which reduces the available observation of earnings deviation companies to 10,791. After comparing the cumulative quarterly earnings and audited annual earnings, 819 observations are identified to have 10% or more earnings deviation, which represents 8% of available sample. Since only these companies are required by the Bursa Malaysia to provide explanations regarding the deviation, only this group is used as sample. However, from 819 observations, only explanations of 731 observations are obtained from Bursa Malaysia's websites which represents 89% of the initial observation of companies with 10% or more of earnings deviation. For each observation, the magnitude of earnings deviation is separated into misstatements and events after reporting period, based on the explanations provided by each company to the Bursa Malaysia. The t-test is used to examine the significant difference in the magnitude of earnings deviation between the two types of reason.

Table 2 shows the distribution of sample based on the range magnitude of earnings deviation. The highest percentage (44%) of companies are those with earnings deviation of between RM1 million to RM10 million, followed by 26% of companies with earnings deviation of between RM100,000 to <RM1 million and 23% of companies with earnings deviation of between RM10 million to <RM100 million. Only 2% of sample has earnings deviation of <RM100,000 and almost 5% of companies has earnings deviation of more than RM100 million. The distribution indicates that a majority of sample companies have earnings deviation of more than RM1 million.

Table 1: Sample selection process

Description	Observations
Total listed companies as at 31 December for the period	12,229
Unavailable financial accounts	121
Financial accounts not in Ringgit Malaysia	18
Newly listed companies	499
Financial period less or more than 12 months	265
Audited quarterly accounts	535
Available sample for observations of earnings deviation	10,791
Companies with<10% earnings deviation	9,972
Companies with 10% or more earnings deviation	819
Unavailable explanations of earnings deviation	88
Available explanations of earnings deviation on Bursa Malaysia websites	731

Table 2: Distribution of sample by magnitude of earnings deviation

Magnitude of earnings deviation	Observations number (%)
Less than RM100,000	16 (2.19)
RM100,000 to<RM1 million	188 (25.72)
RM1 million to<RM10 million	324 (44.32)
RM10 million to<RM100 million	170 (23.25)
More than RM100 million	33 (4.51)
Total	731 (100)

Meanwhile, as can be observed from Table 3, 74% or 540 companies have overstated earnings deviation, whereby the earnings reported in cumulative quarterly accounts are higher than in the audited annual accounts. The balance of 26% (191 companies) has understated earnings deviation, whereby their cumulative quarterly earnings are lower than audited annual earnings. The mean earnings deviation for the total sample is RM18.7 million, with RM22.7 million is recorded as the mean of overstated companies, but only RM7.495 million by understated earnings deviation companies.

5. RESULTS

As can be observed from Table 4, only 33 companies (<5%) have declared events after reporting period as the only reason for earnings deviation. On the other hand, 629 companies (86%) have declared misstatements as the only reason for earnings deviation. Meanwhile, 70 companies (9%) have declared both events after reporting period and misstatements as the reasons for earnings deviation. The distribution indicates that the occurrence of misstatements is more frequent than events after reporting period.

Table 5 presents the descriptive and t-test results of the magnitude of earnings deviation based on misstatements and events after reporting period. For the full sample of 731 observations, the mean of earnings deviation related to misstatements is RM15.2 million, with a standard deviation of RM42.4 million, while a mean of RM3.768 million and a standard deviation of RM40.2 million is observed related to events after reporting period. The t-test shows that the magnitude of earnings deviation related to misstatements is significantly higher than the ones related to events after reporting period at a 1% level. Meanwhile, for sample which have overstated deviations which consists of 540 observations, the mean of earnings deviation related to misstatements of RM18.3 million with a standard deviation of RM48.2 million is higher than the mean related to events after reporting period of RM4.478 million with a standard deviation of RM46.8 million. The t-test also shows that the magnitude of earnings deviation related to misstatements is significantly higher than the ones related to events after reporting period at a 1% level. For the sample companies which have understated deviations which consists of 191 observations, the mean of earnings deviation related to misstatements of RM5.804 million with a standard deviation of RM13.8 million is higher than the mean related to events after reporting period of RM1.76 million with a standard deviation of RM11.1 million. The t-test shows that the magnitude of earnings deviation related to misstatements is significantly higher than the ones related to events after reporting period at a 1% level.

Table 3: Distribution and mean by type of earnings deviation

Earnings deviation	Overstated	Understated	Total
Number	540	191	731
Percentage	73.87	26.13	100
Mean (in RM ’million)	22.700	7.495	18.700

Table 4: Distribution by proclaimed reasons

Proclaimed reasons	Events after reporting period	Misstatements	Both
Number	33	629	70
Percentage	4.51	86.05	9.58

Table 5: Descriptive and t-test analyses

Sample	Mean±SD		t-test
	Misstatements	Events after reporting period	
Full (n=731)	15200000±42400000	3768000±40200000	5.248*
Overstated (n=540)	18,300,000±48200000	4478000±46800000	4.774*
Understated (n=191)	5803607±13800000	1760340±11100000	3.109*

*Significant at 1% level. SD: Standard deviation

Overall, the t-test results show that the magnitude of earnings deviation related to misstatements is significantly higher than the ones related to events after reporting period. While events after reporting period is a mandatory adjustment of the financial accounts, higher magnitude of earnings deviation resulting from misstatements rather than from events after reporting period provides evidence that the reliability of quarterly accounts has been compromised. This suggests that the existence of earnings deviation between cumulative quarterly accounts and audited annual accounts is a signal of low quality quarterly accounts. The finding supports Al-Darasyeh and Brown (1992) and Ibrahim et al. (2009) whom postulated that earnings deviation is an evidence of low quality quarterly accounts.

6. CONCLUSIONS

Many have raised concern on the reliability of quarterly accounts despite its benefits as a tool for more timely dissemination of information. This study extends earlier studies by Al-Darasyeh and Brown (1992) and Ibrahim et al. (2009) whom argued that the earnings deviation between cumulative quarterly accounts and annual audited accounts is an evidence of low reliability of quarterly accounts. These studies have failed to recognize the adjusting events after reporting period of quarterly accounts which may also result in the deviation between both accounts. By using a sample of 731 observations of companies listed on Bursa Malaysia between 2000 and 2012, it is found that only 14% of the sample declared events after reporting period as one of their reasons for earnings deviation, while 95% had declared misstatements. Results of t-test show that the magnitude of earnings deviation related to misstatements is significantly higher than those related to events after reporting period. Thus, implies that the earnings deviation is more related to misstatements in quarterly accounts rather than the occurrence of events after reporting period. This supports the assumptions by Al-Darasyeh and Brown (1992) and Ibrahim et al. (2009) that the deviation between cumulative quarterly earnings and annual audited earnings represents low reliability quarterly accounts. However, it should be noted that the evidence is based on a sample which have excluded observations with <10% deviation, thus the results may only be applied to this type of sample. The finding suggests the need for management and regulators to take steps to enhance the quality of quarterly accounts. Perhaps by involving auditors in reviewing the quarterly accounts (especially for those companies experiencing earnings deviation) can overcome this issue. Meanwhile, researchers should also consider the occurrence of adjusting events after reporting period in their studies on earnings deviation. Future studies could also explore the detailed individual items that may cause the occurrence of earnings deviation.

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