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Events after Reporting Period, Misstatements and Earnings Deviation between Quarterly and Annual Accounts

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Abstract

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Reliability of quarterly accounts has been a concern by many. The occurrence of deviation between earnings reported in audited annual accounts and cumulative quarterly accounts has been posited as a signal of low reliability in quarterly earnings. 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 between 2000 until 2012. It is found that only a total of 14 percent of sample had declared events after reporting period, while 95 percent have declared misstatements as reasons for earnings deviation. At the same time, the mean magnitude of earnings deviation related to misstatements is RM15 million, while only less than RM4 million is related to events after reporting period. 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 steps to resolve the occurrence of earnings deviation. Future studies should also explore the individual items involved in the earnings deviation.

Keywords: Events after reporting period; earnings reliability; interim reporting; misstatements; quarterly accounts.

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1. Introduction

Many countries have mandatorily required listed companies to produce quarterly financial accounts, in addition to the traditional 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 (Ibrahim et.al, 2009; Lightstone et.al, 2012; Bedard & Courteau, 2015). Evidence also indicates that there are many instances where information provided in quarterly accounts may not be accurate (Ibrahim et.al, 2009; Lightstone et.al, 2012; Bedard & Courteau, 2015).

In Malaysia, Bursa Malaysia had required all listed companies to produce quarterly accounts starting for the quarters ending 31st July 1999. 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.

Earlier studies by Al-Darayseh & 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 of Bursa Malaysia in year 2004, Ibrahim et.al. (2009) reported that 64 percent of sample companies of Bursa Malaysia in year 2004 do have earnings deviation between both accounts. Furthermore, 52 percent 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 to 1987, Al-Darayseh & 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 percent 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 & McDaniel, 1989).

However, besides misstatements, earnings deviation can also be resulted from events after reporting period. In the case of Malaysia, two 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-Darayseh & Brown (1992) and Ibrahim et.al. (2009). This study extends the studies by Al-Darayseh & Brown (1992) and Ibrahim et.al. (2009) 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.

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2. Literature Review

In the modern corporate structure, shareholders usually have minimal involvement in the management of corporation 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, financial information has also been disseminated by other means, 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 & Ali 2006).

Traditionally, the financial report 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. It can be observed that the current trend around the world is to replace half-yearly reporting to quarterly reporting. Meanwhile, many have shown the use of quarterly accounts by investors in their investment decision-making (Lee, 2012; Kinney & Trezevant, 1997). 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 quarter. Meanwhile, Kinney & Trezevant (1997), Ismail & Chandler (2005) and Ismail & 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, 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 & Courteau, 2015). Unaudited quarterly accounts expose the accounts to the risk of errors and manipulations by the managers (Ismail & Abdullah, 2009; Comprix et.al. 2012). Without auditing, the reliability of quarterly accounts is dependent on the management. As noted by Rahman & Ismail (2008), 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 evidences by earlier studies have also indicated for the need of auditors' involvement. Pany & Smith (1982) found increasing reliability of quarterly accounts by financial analysts with the increasing auditor association. Manry & Tiras (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 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 & 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 found higher forecast errors in fourth quarter accounts than other quarters. In addition, the evidence by Kinney & Trezevant (1997), Ismail & Chandler (2005) and Ismail & Abdullah (2009) of the practices of deferment of exceptional items from earlier to fourth quarter can also be viewed as a settling-up phenomenon.

3. Hypotheses

The basic idea of the preparation of quarterly accounts is that, the cumulative quarterly earnings would be similar to the audited annual earnings (Al-Darayseh & Brown, 1992; Ibrahim. et.al 2009; Ismail & 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-Darayseh & 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. Two months lapse between the production of fourth quarterly accounts and the audited annual accounts expose the accounts to the 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 to 2012. 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 less than 12-months period and 535 companies which have audited quarterly accounts are excluded, which reduces the available

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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 percent or more earnings deviation, which represents 8 percent 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 percent of the initial observation of companies with 10 percent 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 reasons.

From 731 observations, the highest percentage (44 percent) of companies are those with earnings deviation of between RM1 million to RM10 million, followed by 26 percent of companies with earnings deviation of between RM100,000 to less than RM1 million and 23 percent of companies with earnings deviation of between RM10 million to less than RM100 million. Only 2 percent of sample has earnings deviation of less than RM100,000 and almost 5 percent of companies has earnings deviation of more than RM100 million. The distribution indicates that a majority of sample have magnitude of earnings deviation of more than RM1 million. Meanwhile, based on type of earnings deviation, 74 percent (540 companies) have overstated earnings deviation, whereby earnings reported in cumulative quarterly accounts is higher than in audited annual accounts. The balance of 26 percent (191 companies) has understated earnings deviation, whereby their cumulative quarterly earnings is 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

From the total sample of 731 observations, it is observed that only 33 companies (less than 5 percent) have declared events after reporting period as the only reason for earnings deviation. On the other hand, 629 companies (86 percent) have declared misstatements as the only reason for earnings deviation. Meanwhile, 70 companies (9 percent) have declared both events after reporting period and misstatements as the reasons for earnings deviation.

Table 1 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 one percent 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 one percent 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 one percent level.

Table 1. Descriptive and t-test analyses

Sample	Misstatements		Events after reporting period		t-test
	Mean	Std. dev.	Mean	Std. dev.	
Full (n=731)	15,200,000	42,400,000	3,768,000	40,200,000	5.248*
Overstated (n=540)	18,300,000	48,200,000	4,478,000	46,800,000	4.774*
Understated (n=191)	5,803,607	13,800,000	1,760,340	11,100,000	3.109*

* Significant at 1 percent level

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-Darayseh & Brown (1992) and Ibrahim et.al. (2009) and whom postulated that earnings deviation is an evidence of low quality quarterly accounts.

6. Conclusions

This study extends earlier studies by Al-Darayseh & 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. Both studies have failed to recognize the possible events after reporting period of quarterly accounts which may also result in the deviation between both accounts. It is found that only a total of 14 percent of the sample declared events after reporting period as one of the reasons for earnings deviation, while 95 percent 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-Darayseh & 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 less than 10 percent deviation, thus the results may only be applied to this type of sample. The finding suggests the need for management and regulators to enhance the quality of quarterly accounts. Perhaps by involving auditors in reviewing these quarterly accounts (especially for those companies experiencing earnings deviation) can overcome this issue. Meanwhile, researchers should also need to consider the occurrence of events after reporting period in their studies on earnings deviation. Future studies could also explore the individual items that occur in the earnings deviation.

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