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How frequently should listed companies report results?

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ABSTRACT

On August 17, 2018, President Trump announced that he had asked the Securities and Exchange Commission (SEC) to study whether U.S. listed companies should file interim financial statements at half-year intervals instead of on a quarterly basis. This essay examines the question underlying the President's concern: how frequently should public companies file interim statements? A review of accounting standards, regulations, and research reveals that there is (i) no agreed-upon best practice for reporting frequency, (ii) compelling evidence that analyst earnings estimates arising from interim reporting give rise to executive angst, and (iii) some evidence that lengthening reporting intervals will harm investors. The short-term implication of this essay is that readers of this journal should participate in SEC deliberation on this issue. The long-term implication is that we need to encourage accounting scholars from various disciplines to try to answer the President's question.

Introduction

On Friday, August 17, 2018, U.S. President Donald Trump indicated that he asked the Securities and Exchange Commission (SEC) to study whether it should the extend the filing frequency for financial statements of listed firms from quarterly to six-month intervals. Rarely does the President of the United States comment on financial accounting policy. Perhaps the last time this happened was sixteen years earlier when George W. Bush signed the Sarbanes–Oxley Act into law.

President Trump's implicit research question is whether there is a "Goldilocks" frequency for reporting financial results to investors. A too-long interval brings risk of investment decisions being made on the basis of stale information. A too-frequent interval brings risk of management teams making myopic decisions to meet interim earnings targets set by Wall Street analysts or a firm's own executives. A simple survey of national practices suggests there is no agreed-upon answer. Table 1 shows that the five largest (and arguably) most successful economies in the world have chosen three different rules for listed companies.

A literature search reveals that interim statement reporting frequency garners comparatively little attention among accounting scholars. For example, not a single article in RAR's 30-year history has focused on this topic. The purpose of this essay is to summarize relevant accounting standards, regulation, and research to spur our readers to contribute to the SEC's deliberations and then search for an evidence-based answer.

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Interim accounting and reporting

Financial statements covering periods of less than a year are known as interim reports. These statements provide users with timely information about a firm's financial position and performance plus insight into seasonality of operations. The primary measurement issue is that accruals arising from significant transactions loom large against the smaller revenue or earnings bases associated with interim accounting periods.

Financial accounting rules require revenues and expenses for interim statements to be recognized with the same principles used to prepare annual financial statements. To facilitate comparisons across periods, preparers use allocation procedures to express interim operating balances as integral components of annual accounts. For example, interim tax provisions use annual estimates of pretax income and income tax rates. Nonrecurring items, by contrast, are recognized fully in the appropriate interim period.

Accounting standards for interim reporting have brought little controversy. The first substantive U.S. standard, Accounting Principles Board Opinion 28 (*Interim Financial Reporting*) was published in 1973, thirty-four years after formation on the original Committee on Accounting Procedure. While the Financial Accounting Standards Board (FASB) made a few technical enhancements over the next forty years, Opinion 28′s basic principles remain unchanged as part of the current FASB codification.[1]

[1] In August 2018, the FASB added a new chapter to its Conceptual Framework entitled "Notes to Financial Statements." This guidance does not modify accounting standards used to measure balances in interim statements but alerts preparers that notes appended to interim statements should disclose any changes in account-

Table 1
Financial reporting intervals of listed firms in the world's five largest economies.

Ordinal size of economy	Country	Required interim reporting frequency
1	United States	Quarterly
2	China	Half-year for financial statementsQuarterly for key accounting data
3	Japan	Quarterly
4	Germany	Half-year
5	United Kingdom	Half-year

International accounting standards for interim reporting have similarly provoked little controversy. The International Accounting Standards Committee (predecessor to today's International Accounting Standards Board) issued International Accounting Standard 34 (also titled *Interim Financial Reporting*) in 1998, twenty-five years after formation of the Committee. The Standard has been modified just once.

Whereas standard setters establish rules for measuring interim balances, stock exchanges and securities regulators determine the time intervals over which interim statements should be disclosed.[2]

Regulators have vacillated over the appropriate frequency of interim reports. In the 1920 s, the New York Stock Exchange required listed companies to send quarterly statements to shareholders. The American Stock Exchange and regional stock exchanges had more modest listing requirements. Noncompliance showed the importance of government involvement in enforcing interim reporting rules. The SEC initially required registrants to file annual financial statements in 1934. The SEC briefly experimented with quarterly reporting in 1953, moved to mandatory semi-annual reporting in 1955, and then required quarterly reporting in 1970. In 2007, the United Kingdom moved from requiring semiannual to quarterly reports and then reversed the decision in 2014. The European Commission required quarterly reporting 2004 and then moved to a half-year convention in 2013.

Asian markets have shown more consistency. Japan has required quarterly reporting. China has chosen a middle path with required quarterly disclosures for select accounting balances and half-year filing of unaudited financial statements with footnotes.

In summary, accounting standard setters agree upon measurement standards for interim accounting balances while securities regulators offer different views regarding appropriate intervals for reporting interim results.

Earnings estimates and guidance

The present controversy concerns whether interim reporting rules breed dysfunctional managerial behaviors. Interim reports give rise to interim earnings estimates published by securities analysts. Analysts form expectations about a firm's financial prospects, regardless of whether management discloses explicit financial projections (Berenson, 2003). Managers compare consensus (average) estimates with internal projections to decide whether expectations are a cause for concern (Ajinkya & Gift, 1984). If expectations are too high, reported income will fall short and possibly spark a sell-off of the company's stock. If expectations are too low, reported results will beat the benchmark but influence analysts to ratchet earnings expectations to higher levels (Goedhart, Russell, & Williams, 2001; Richardson, Teoh, & Wysocki, 2004), setting the stage for a future earnings miss.

There is compelling evidence of stock market rewards for meeting or beating expectations (DeFond & Park, 2001; Kasznik & McNichols, 2002; Lopez & Rees, 2002) and penalties for failing to do so (Kinney et al. 2002; Skinner & Sloan, 2002). Chief Executive Officers (CEOs) are more likely to be fired when their firms' earnings consistently miss expectations (Puffer & Weintrop, 1991). Stock price declines also affect executives who have equity-based compensation, wish to use their firm's shares as currency to make acquisitions or defend against a takeover, or are evaluated based on the performance of their firm's stock price (Hutton, Miller, & Skinner, 2003). Companies that consistently miss estimates suffer poor stock price performance even if they report healthy growth rates or returns on capital (Koller, Raj, & Saxena, 2013).

An August 7, 2018, email sent by Elon Musk to Tesla employees illustrates these tensions:

> As a public company, we are subject to wild swings in our stock price that can be a major distraction for everyone working at Tesla, all of whom are shareholders. Being public also subjects us to the quarterly earnings cycle that puts enormous pressure on Tesla to make decisions that may be right for a given quarter, but not necessarily right for the long-term.[3]

Musk describes the pain felt by executives of listed companies when stock market penalties follow the reporting of quarterly results that miss expectations. Further, he shares how these executives may be tempted to make myopic decisions to avoid future shortfalls.

Scholars find evidence that managers use three strategies to avoid reporting shortfalls: cash flow-changing business decisions ("real" management actions such as cutting advertising spending), accrual-changing accounting decisions (e.g., adjusting bad debt reserves), and expectations-changing actions such as talking down analyst estimates (Burgstahler & Eames, 2006). Each of these strategies may produce adverse consequences. Real management may weaken a firm's earnings power, accrual management may give rise to fraudulent financial reporting, and expectations management may run afoul of securities laws that forbid selective disclosure of material, nonpublic information.

A second stream of accounting research focuses on guidance, a tool used by executives to mitigate the risk of reporting shortfalls. Voluntary disclosure of financial prospects (e.g., "we expect next quarter's earnings to be between $0.95 and $1.05 per share") improves analyst forecast accuracy (Clement, Frankel, & Miller, 2003; Hutton, 2005; Irani & Karamanou, 2003; Waymire, 1986), allows executives to build reputations for transparency (Williams, 1996), increases share liquidity (Coller & Yohn, 1997), reduces the cost of capital (Hutton & Stocken, 2009), and provides litigation protection through early disclosure of bad news (Skinner, 1994). The demonstrated ability to forecast accurately also brings a reputation for managerial competence (Trueman, 1986).

Public forecasts also expose executives to damaged reputations if reported results miss guided estimates (Graham, Harvey, & Rajgopal, 2005). Some managers have gone to extreme lengths to

ing principles used to recognize, measure, or present line items in the most recent statements or the effects of any significant seasonal trends on these reported balances.

[2] Butler, Kraft, and Weiss (2007) and Leftwich, Watts, and Zimmerman (1981) provide helpful background information on U.S. regulation of interim reporting frequency.

[3] Downloaded from https://www.tesla.com/blog/taking-tesla-private%20 on August 24, 2018.