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THE RELIABILITY OF QUARTERLY FINANCIAL REPORTS OF COMPANIES IN MALAYSIA

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ABSTRACT

This study examines the reliability of corporate quarterly reports of Malaysian companies by analyzing the reporting of exceptional items. The quarterly reports are likely to be unreliable if companies tend to defer the reporting of exceptional items to the final quarter. In examining the quarterly reports of 114 companies listed on the Kuala Lumpur Stock Exchange, this study provides evidence that a majority of companies defer the reporting of exceptional items to the fourth quarter. It is also observed that a majority of companies made negative adjustments during the fourth quarter. Therefore, the quarterly reports are likely to be unreliable, and there are reasons to believe that companies manage their quarterly earnings. In addition, this study provides evidence that non-profitable companies defer the reporting of exceptional items to the fourth quarter more than the profitable ones. However, there is no evidence of association between the deferment of the recognition of exceptional items and the size, growth, and leverage of a company.

JEL classification: G34, M41

Key words: Quarterly financial reporting, Reliability, Earnings management

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1. INTRODUCTION

Following the 1997/98 Asian financial crisis, Malaysian financial reporting has undergone a speedy reform with the objectives of improving transparency and restoring market confidence. One of the measures undertaken to achieve the objectives is to require companies listed on the Kuala Lumpur Stock Exchange (KLSE) to publish quarterly reports. In order to achieve the desired objectives, quarterly reports are to be useful, that is, to be able to provide users with timely and high quality financial information.

Reliability is one of the primary qualitative characteristics of useful accounting information. A report would be considered reliable if it is free from errors and bias, faithfully represents what it purports to represent, reflects the economics substance of events and transactions, is prudent and complete in all material respects (see FASB, 1980; Malaysian Accounting Standards Board (MASB), 1999b). From the Islamic perspective, misstatement of information with the intention of manipulation is against Islamic values. Islam places great emphasis on social accountability, rather than individual accountability; therefore, the self-interest of preparers, regardless of society's needs, is something to be avoided (Baydoun and Willet, 2000). This paper is concerned as to whether the quarterly reports are free from errors. Lack of auditor involvement, the ambiguity of accounting standards and the adoption of the integral method (as opposed to the discrete method) are argued to be responsible for abuse in the reporting of interim information (Mendelhall, Nichols and Palepu, 1988; Doran, 1995; National Commission on Fraudulent Financial Reporting, 1987). Since interim reporting is not subjected to external audit, it is more exposed to the risk of accounting errors and the practice of earnings management. Auditor involvement was argued to be necessary in developing a more accurate and meaningful interim report and was seen as a means of increasing market credibility (Baines, Tanewski and Gay, 2000). In the US, Kinney and McDaniel (1989) noted that since only year-end statements are audited, the fourth quarters' results might include corrections of previous errors in reported interim earnings. Unlike Malaysian companies whose fourth quarterly reports are issued separately from and before the annual reports, companies in the US are required to incorporate the fourth quarterly reports in the annual reports. Therefore, the fourth quarterly reports of companies in the US are, in fact, audited.

Generally, there are two different views that could be employed as a basis of preparing the interim financial statements – the integral and the discrete approaches. The integral perspective regards an interim period as part of the larger annual reporting cycle. Bartsch (1989) for example stated:

> "Under this perspective, deferrals, accruals and estimates reported in each interim statement reflect the accountant's belief of what is likely to transpire relative to the results of operations for the entire year. Essentially, interim-period allocations are components of interim accounting reports prepared by the integral method."

The discrete view believes that each interim period should be treated as an accounting period distinct from the annual cycle. Under this method, deferrals, accruals and estimates at the end of each interim period should be determined by the principles that apply to the annual periods in which the transactions reported in the interim period should reflect the economic activity of that period, rather than outcomes based on forecasts of the operations of the forthcoming year. The discrete view rests on the belief that when a period is both a discrete accounting period and a segment of the total life of an enterprise, the interim period should likewise be seen as both a discrete accounting period and a fraction of an annual period (MASB, 1999a).

Hussey and Woolfe (1994) argued that errors and manipulation would be more likely to occur under the integral approach, thus resulting in unreliable information. In addition, because under or over allocations are more likely with the integral approach, this may cause the distortion of results in the subsequent period. Hence, quarterly reports prepared using the discrete approaches are argued to be more reliable than those prepared using the integral approach. Therefore, it is expected that companies adopting the discrete method would be less likely to defer the reporting of exceptional items to the final quarter compared to those adopting the integral approach.

Quarterly reports of Malaysian companies are not subjected to external auditor involvement, and at the time this study was undertaken the related accounting standard has not yet been enforced. Thus, it is expected that there would be higher management discretion in reporting the quarterly results, and the quarterly reports are more likely to contain errors. *MASB 26 Interim Financial Reporting* has only become operative since 1 July 2002. The standard is materially consistent with *IAS 34 Interim Financial Reporting* issued in 1999.

The issue regarding the reliability of quarterly reports has not been previously examined in Malaysia. Therefore, it is felt necessary that this paper should fill the gap by observing if the quarterly reports of Malaysian companies are reliable. The study will provide evidence on the reliability of quarterly reporting in an environment where there is no regulation on auditor involvement and the related accounting standard has not yet been enforced. In addressing the issue, this study examines the reporting of exceptional items in published quarterly reports of companies for 2001, which are the latest reports at the time this study was undertaken.

Delaying the reporting of exceptional items to the final quarter implies that the first three quarterly reports are misstated, and there would be reasons to suspect that companies manage their quarterly earnings. This study will also determine whether bad new is delayed by examining if the recognition of negative exceptional items, in particular, is deferred to the final quarter. Drawing on the signaling and the "delay bad news", theory, this study will provide evidence of whether the practice of deferring the recognition of exceptional items to the final quarter is associated with company specific characteristics such as the size, and performance of a company.

Under the *Listing Requirements*, a company is required to disclose the amount and nature of exceptional items in the quarterly reports. The MASB does not specifically use the term "exceptional items" in *MASB 26*. However, they are likely to refer to items of income and expense within profit or loss from ordinary activities whose disclosure (due to size, nature or incidence) is relevant in explaining the financial performance of a company (see Paragraph 18 of *MASB 3, Net Profit of Loss for the Period, Fundamental Errors and Changes in Accounting Policies*). According to *MASB 3* (MASB, 1999c, paragraph 20), circumstances which may give rise to "exceptional items" include write-downs of inventories and fixed assets as well as the reversal of such write-downs, a restructuring of activities, disposals of fixed assets and investments, discontinued operations, litigation settlements and other reversals of provisions.

Having discussed the rationale and objectives of this study, the rest of the paper is organized as follows. The next section will discuss the background information about quarterly financial reporting in Malaysia.

A review of literature will be presented next. Following that, there will be sections on hypothesis development and research methods. A section that discusses the results of the study follows, and finally the conclusions will be offered.

2. BACKGROUND OF QUARTERLY REPORTING IN MALAYSIA

In March 1999 the KLSE announced the requirements on quarterly reporting of financial statements by public listed companies to replace half-yearly reporting. The requirements were effective for quarters ending on or after 31 July 1999. The implementation of quarterly reporting is based on the view that the reports would aid informed investing, reduce investment risk, and increase the accountability of those companies (KLSE, 1999). The introduction of quarterly reporting in Malaysia was a result of the outbreak of the Asian financial crisis of 1997/1998. Various factors were associated with the financial crisis, and the lack of disclosure and transparency was believed to be a contributing factor for the market failure in East Asia countries (Rahman, 1998). One way of strengthening corporate accountability was to introduce quarterly reporting (Alis, 1999). Such timely information would enhance investors' confidence in the capital market, reduce uncertainties and help improve users' decisions (Capulong, et al., 2000).

The quarterly reports are to be submitted to the KLSE within two months of the quarter-end, upon which the Exchange will release it to the public. Apart from being more frequent and more timely compared to the half-yearly report, the contents of the quarterly report are much more comprehensive. However, the reports, including that of the fourth quarter, are not subjected to external auditor involvement.

Following the KLSE's requirement on quarterly financial reporting, MASB issued *Draft Statement of Principle (DSOP) 4, Interim Financial Reporting*, in 1999 to assist preparers on the issue of recognition and measurement in reporting quarterly reports. The *Statement* was designed as a formulation and development of best practice. After going through the due process of standard setting, in which no major changes have been made, the *Statement* became a Standard in 2002, known as *MASB 26, Interim Financial Reporting*.

The *Standard* is essentially an adoption of *IAS 34, Interim Financial Reporting,* issued by the International Accounting Standards Committee (IASC) in 1998.

The content of an interim financial report prescribed in *MASB 26* should include, at a minimum, a condensed balance sheet, a condensed income statement, a condensed statement showing either all changes in equity or changes in equity other than those arising from capital transactions with owners and distribution to owners, a condensed cash flow statement, and selected explanatory notes. In measuring and reporting transactions in the quarterly reports, both the discrete and integral approaches are applicable, depending on the nature of the transactions. However, the discrete approach is the main view taken by *MASB 26* (MASB, 2002) in dealing with most of the transactions.

3. LITERATURE REVIEW

A number of studies have been conducted to determine the reliability of interim reports and the methods used vary. Studies conducted by Givoly and Ronen (1981) in the US, and Fortin, Martel and Trudeau (1997) in Canada examined the net income reported in each of the four quarterly reports. They provide evidence that not all quarters' data are equally reliable, and the fourth quarter net income accounted for the highest percentage of the annual net income. This suggests that management makes major adjustments in the fourth quarter.

Collins, Hopwood and McKeown (1984) and Doran (1995) examined the forecasts of earnings per share (EPS). The former examined the predictability of earnings per share (EPS) for each of the four quarters by analyzing the forecasts by security analysts and time series models. The accuracy of the forecasts decreased as the year progressed, and the fourth quarter's forecast was found to be the least accurate. It is argued that the fourth quarter settling-up effect is the most appropriate explanation for the findings. It is often difficult to forecast the EPS of the fourth quarter with better precision because the earnings of the fourth quarter would contain the earnings that would have been reported in that quarter plus any adjustments necessitated by corrections of estimates and errors from the previous three quarters. The fourth quarter settling-up effect was, in turn, argued to be the result of the use of the integral method and the fact that the quarterly statements (except for the fourth quarter) are not audited. Doran (1995) compared the accuracy of forecasted EPS by analyzing two groups of firms. One group consisted of the earnings forecast of firms with only interim future quarters, while the other group consisted of the earnings forecasts that conclude at fiscal-year-end. The findings indicate that the fiscal-year-end group demonstrates relatively unfavorable (negative) earnings performance. Regression analysis indicates that the difference in earnings performance is due to an interim period earnings overstatement bias. The results support the notion that management may have incentives to overstate interim earnings by delaying bad news and where the integral method is adopted they may make optimistic full-year estimates for interim reporting purposes.

Kinney and McDaniel (1989) analyzed errors that were discovered in quarterly earnings and corrected in year-end statements. They found that on average the error corrections were negative, indicating that earnings originally reported were overstated. The findings also indicate that reported corrections tend to be in statements of companies that are relatively small, less profitable, have relatively more debt, have lower growth, and receive uncertainty qualified audit opinions. It was noted that the findings were consistent with the practice of interim window dressing by management of financially weak firms.

Using the same sample of companies as in the above research, Kinney and McDaniel (1993) investigated audit delay for firms that corrected previously reported quarterly earnings. They reveal that audit delays for firms correcting previous quarterly earnings were significantly larger than those of matched firms without such corrections. There is also evidence that the delay is significantly related to the magnitude of quarterly earnings overstatement. This suggests that there is an intention by the management of the firms to deceive or manage quarterly earnings, which is likely to increase year-end auditing.

Al-Darayseh and Brown (1992) attempted to find any evidence of income enhancement in quarterly statements by examining the distribution of integers appearing in the first and second digit of income before extraordinary items. The findings reveal that, unlike the annual data, the quarterly data do not conform to a random distribution and thus suggest that firms may have rounded their quarterly data. The results indicate that the quarterly financial reports are less accurate than the annual reports and they argued the fact that the quarterly reports are not subject to auditing might explain the results.

The works of Fried, Schiff and Sondhi (1987), Kinney and Trezevant (1997), and Ettredge, et al. (2000) are of particular interest to this study. The use of "exceptional items" (termed as unusual, non-routine or special items in other studies) such write-offs in determining the reliability of the quarterly reports is based on these studies. Fried et al. (1987) provided evidence that over the years 1980 to 1985, 52 percent of the write offs were reported in the fourth quarter. This is equivalent to 64 percent of the dollar value of the write-offs and the pattern of reporting was found in each of those years and across all industries.

Kinney and Trezevant (1997) provided evidence that 'special items' were used to manage income and more of the items are recognized in the fourth quarter than in any other quarter. This thus supports previous literature that earnings reported in the fourth quarter differ significantly from earnings reported in earlier quarters. Considering that there is evidence that the special items are used to manage income, the results imply that earnings reported in the fourth quarter might be subjected to more manipulation than earnings reported in other quarters.

Ettredge et al. (2000) analyzed quarterly reports of US companies that report at least one non-routine adjustment during 1988/89. They observed that a large number of non-routine items such as asset write-downs were recorded in the fourth quarter. They also found that the frequency and proportion of the non-routine items reported in the first three quarters were greater for companies with timely audit reviews. These companies reported a lower number and proportion of adjustments during the fourth quarter. The hypothesis that the number of adjustments made during the first three quarters is positively related to having a timely audit review is supported in this study. In other words, the extent of auditor involvement is inversely related to the deferral of adjustments to the fourth quarter.

Several observations are noted from the above findings. A number of studies provided evidence that companies used quarterly reports to manage earnings and bad news is often delayed to the final quarter. There is an indication that quarterly reports lack one of the essential ingredients of quality reporting, that is reliability. In some jurisdictions, measures were being taken to improve the reliability of interim reporting. They include regulations for auditor involvement, and the shifting of approach from the integral to the discrete approach of accounting. As none of the above studies is conducted in Malaysia, it is interesting that this be conducted.

4. HYPOTHESIS DEVELOPMENT

Although there are various methods of determining the reliability of quarterly reports, none is superior to the other. This study adopts the method used by Kinney and Trezevant (1997) and Ettredge et al. (2000). This study determines if companies defer the reporting of exceptional items to the fourth quarter. This is accomplished by observing the incidence of exceptional items in each of the four quarterly reports. 'Settling-up' is likely to occur if the incidence of exceptional items is more frequent during the fourth quarter than any other quarters. In this respect, for each company under study, the proportion of the incidence of exceptional items in each quarter to the total incidence of exceptional items reported in all quarters is calculated. There will be reasons to suspect that companies purposely defer the recognition exceptional items if the fourth quarter reports the greatest proportion of the number of exceptional items. The greater the proportion of exceptional items reported in the fourth quarter is, the less the likelihood that the quarterly reports are reliable.

Auditor involvement and the enforcement of accounting standards have been recognized as ways to enhance the reliability of financial information. Lack of regulation and enforcement will result in companies have more discretion in reporting their financial information and this will, in turn, lead to non-quality information. Because the quarterly reports of Malaysian companies are not subjected to auditor involvement and the relevant accounting standard has not yet been enforced at the time this study was undertaken, it is hypothesized that there are tendencies for companies to defer the recognition or exceptional items to the final quarter.

Managers are also expected to portray positive information about their companies, and therefore, bad news is likely to be delayed to the fourth quarter. Based on the "delay bad news" theory, earnings of the first three quarters are more likely to be overstated than understated. In other words, the exceptional items reported in the final quarter are likely to be negative. The above discussion leads to the following hypothesis:

H_1: There are tendencies for companies to defer the recognition of exceptional items to the fourth quarter.

H_2: The exceptional items deferred to the fourth quarter are likely to be negative.

This study hypothesizes that the deferment of exceptional items to the final quarter is associated with the size of a company. The influence of size on the reliability of quarterly reporting can be explained by agency and propriety cost theories. It is argued that large companies are more closely watched by the government and greatly followed by the analysts. Facing this public scrutiny and in an attempt to reduce agency costs, large companies are likely to improve their reporting. Thus, the tendency to defer exceptional items is less likely with large firms. In terms of propriety cost, small companies may involve higher cost for disclosing information compared to larger companies. Smaller firms are argued to report more errors because they are expected to have weaker internal controls. Kinney and McDaniel (1989) argued that larger firms are expected to have stronger internal controls because they are more likely to have internal audit teams whose activities might reduce the number of errors found in the quarterly reports. Smaller firms, on the other hand, would be more likely to depend on the external auditors for error detection. Where auditor involvement is not mandatory, as in the case of quarterly reporting, it is expected that small companies are more likely to delay the reporting of exceptional items to the fourth quarter.

Ettredge et al. (1994) provided evidence that size was negatively associated with the extent of adjustments made in the fourth quarter, and Kinney and McDaniel (1989) found that the size of a company was negatively associated with the number of errors found in the quarterly reports. Based on the above discussion, this study hypothesizes that the size of a company negatively influences the deferring of exceptional items to the final quarter. The hypothesis to be tested is:

H_3: The deferment of exceptional items to the final quarter is negatively associated with the size of a company.

The performance of a company is also argued to play a role in influencing the reliability of a quarterly report. Advocated by signaling and delay bad news theories, it is predicted that there is a negative association between company performance and the deferring of exceptional items. Such association exists because managers of successful firms will disclose detailed information to signal in order to support the continuance of their positions and compensation arrangements (Inchausti, 1997). It is also argued that management with good new is likely to disclose more information than management with bad news (Naser, 1998). Thus, it is less likely that healthy companies would delay disclosing any material information to the end of the year compared to non-successful companies. Besides, it has been posited that companies are motivated to signal to investors that their performance is sound and thus bad news is delayed. Kinney and McDaniel (1989) contended that financially troubled firms are more likely to window dress in an attempt to hide their problems. They hypothesized that the profitability and growth of a company were negatively associated with the number of errors found in the quarterly reports. In addition, they hypothesized that the leverage of a company was positively related to the number of errors. This is because the higher the ratio of debt to total assets, the higher the probability of a company being a failure. Kinney and McDaniel (1989) provided evidence to support the hypotheses.

This study assumes that the performance of a company is directly associated with its profitability and growth, and inversely associated with its leverage. Consistent with Kinney and McDaniel (1989), this study assumes that highly leveraged firms are likely to be failures. Based on the above discussion, this study attempts to determine if the deferment of exceptional items to the fourth quarter is associated with the profitability, growth and leverage of a firm. The hypotheses to be tested are:

H_4: The deferment of exceptional items to the final quarter is negatively associated with the profitability of a company.

H_5: The deferment of exceptional items to the final quarter is negatively associated with the growth of a company.

H_6: The deferment of exceptional items to the final quarter is positively associated with the leverage of a company.

5. RESEARCH METHODS

5.1 SAMPLING

In determining the sample, companies listed on the KLSE before January 2000 and which have year-ends of 31 December were initially identified. Companies listed under the finance, trusts and closed-end funds classification of the KLSE listing were excluded from the sample. This is because those companies have additional requirements with respect to financial reporting. After omitting these companies, there were 351 companies in the sampling frame.

The sampling frame was generated from the list of companies published in the *Investors Digest* (KLSE, 2000). Quarterly and annual reports prepared for the year 2001 were the subjects of investigation. This period was chosen because it is expected that companies were already accustomed to the quarterly disclosure requirement provided under the *KLSE Listing Requirements* since it came into effect in July 1999. Quarterly reports submitted to the KLSE and made available on the KLSE Listing Information Network (KLSE LINK) are the data source used in this study. However, only 114 out of the 351 companies (32.5 percent) disclosed exceptional items in at least one of the quarterly reports during 2001. Therefore, only the reports of these 114 companies are the subject of further investigations. The distribution of companies according to board listing (main or second board of the KLSE) and sectors is shown in Table 1.

5.2 DATA ANALYSIS

Each of the 114 companies is observed for the reporting of exceptional items in each of the four quarterly reports. The distribution of the incidence of exceptional items during the four quarters should be equally likely if companies apply the discrete method of reporting, whereby

TABLE 1
Distribution of Companies

	Frequency	Percent
Board:		
Main	81	7.1
Second	33	28.9
Total	114	100.0
Sectors:		
Trading and Services	32	28.1
Industrial Products	22	19.3
Plantation	16	14.0
Property	15	13.1
Consumer Products	13	11.4
Construction	9	7.9
Others	7	6.2
Total	114	100.0

each interim period should be treated as an accounting period distinct from the annual cycle. Companies are likely to defer the reporting of exceptional items and there will be ground for suspicion that the quarterly reports are unreliable if the incidence of exceptional items reported in the fourth quarter is greater that that reported in the earlier quarters. For example, there will be a high likelihood of deferment if none of the exceptional items are reported in the first three quarters, but instead they are all reported in the fourth quarter.

The proportion of the incidence of exceptional items reported in each quarter was not normally distributed. Therefore, the non-parametric tests are adopted in this study. Sign tests and the one-sample Kolmogorov-Smirnov are used to test the first and second hypotheses, respectively. To test the remaining hypotheses, Chi-square tests are employed. In applying the Chi-square tests, data with respect to each of the variables (proportion of the incidence of exceptional items, size, profitability, growth and leverage) are divided into two groups, and the basis of classification is as shown in Table 2. Companies are assumed to defer the reporting of exceptional items if the proportion of the items reported in the fourth quarter is greater than that reported in any other quarter. Where total assets and leverage are concerned, median scores are used to differentiate small and large companies, and lowly and

TABLE 2
Classification of Variables

Deferment of exceptional items	Likely if the fourth quarter discloses more exceptional items than does any other quarter, otherwise less likely.
Size	Small if total assets are less than the median, otherwise large
Profitability	Profitable if earnings are positive, otherwise negative.
Growth	Positive if change in net sales is positive, otherwise negative.
Leverage	Low if ratio of debt to total assets is less than the median, otherwise high.

highly leveraged companies. As for profitability and growth, data are divided according to their signs (positive or negative).

6. RESULTS AND DISCUSSIONS

Upon reviewing the quarterly reports of the 114 companies in the sample, it is observed that exceptional items are more likely to be reported in the fourth quarter than in any other quarters. Table 3 shows that 90 (78.9 percent) companies reported exceptional items in the fourth quarter. The number decreases as the quarter moves away from year-ends with the first quarter recording the number of 41 (36 percent) companies having exceptional items.

Companies are also observed for the incidence of exceptional items reported in each quarter. Table 4 shows that 64 companies (56.1 percent) reported greater incidences of exceptional items in the fourth quarter than in any other individual quarter. Out of that, 48 companies (42.1 percent) reported greater incidences of exceptional items in the fourth quarter than in the first three quarters combined.

Table 5 reveals that the overall mean proportion of the incidence of exceptional items reported by companies varies among quarters. The proportion increases the quarter moved towards year-end, and the fourth quarter reported the greatest proportion of the incidence of exceptional items (50.53 percent), and the first quarter reported the lowest proportion (10.40 percent).

TABLE 3
Companies Reporting Exceptional Items by Quarter

Quarter	Frequency	Percent
1st	41	36.0
2nd	53	46.5
3rd	58	50.9
4th	90	78.9

TABLE 4
Incidence of Exceptional Items

	Yes		No	
	Freq.	%	Freq.	%
Companies reporting incidence of exceptional items in the 4th quarter more than in any other quarter	64	56.1	50	43.9
Companies reporting incidence of exceptional items in the 4th quarter more than in the first three quarters combined	48	42.1	66	57.9

Results of sign tests as shown in Table 5 indicate that the proportion of the incidence of exceptional items recognized in the fourth quarter is significantly higher than that reported in each of the other quarters. The findings thus provide evidence that there are tendencies for managers to defer the recognition of exceptional items to the final quarter.

The first hypothesis is thus supported. It supports the notion that managers use the fourth quarter as a ‘settling-up period’ because the quarterly reports are not subject to auditing, and the fact that the use of the discrete method has not been enforced. There may be a tendency for management manipulation of income during the first three quarters, thus resulting in unreliable reports. Previous findings, among others, by Kinney and Trezevant (1997) and Fortin, Martel, and Trudeau (1997) are thus substantiated.

TABLE 5
Descriptive Statistics on the Proportion of Incidence of Exceptional Items

Quarter	Mean	Std. Dev.	Sign test: Difference between 4th and	Sign test: *Z*-value	Sign test: Sig. (2-tailed)
1st quarter	0.1040	0.187	1st quarter	-7.159	0.000**
2nd quarter	0.1696	0.247	2nd quarter	-5.927	0.000**
3rd quarter	0.2211	0.315	3rd quarter	-5.613	0.000**
4th quarter	0.5053	0.373	4th quarter	-7.159	0.000**

In this study, the quarterly reports are also observed for signs of the exceptional items reported in each quarter, that is, whether they are positive or negative in nature. Table 6 shows that as the quarter moves towards year-end, a greater number of companies are reporting exceptional items, and negative exceptional items are more prevalent compared to the positive items. During the fourth quarter, 50 percent of the companies reported negative exceptional items, and only 28.9 percent reported positive items.

Since more negative rather than positive exceptional items are reported in the final quarter, the findings provide an indication that the earnings of the earlier quarters are more overstated than understated. Results of the one-sample Kolmogorov-Smirnov test show that the difference between the number of companies reporting negative and positive exceptional items is significant. The findings are consistent with those of previous studies (for example, Doran, 1995). Thus, the

TABLE 6
The Signs of Exceptional Items Reported in Each Quarter

	1st Quarter		2nd Quarter		3rd Quarter		4th Quarter	
	Freq.	%	Freq.	%	Freq.	%	Freq.	%
Negative	21	18.4	33	28.9	31	27.2	57	50.0
Zero	73	64.0	61	53.5	56	49.1	24	21.1
Positive	20	17.5	20	17.5	27	23.7	33	28.9
Total	114	100.0	114	100.0	114	100.0	114	100.0

‘delay bad news’ theory or the notion that management may overstate interim earnings by delaying the release of negative information until the final quarter is supported.

Auditor involvement and that adoption of the discrete method in recognizing income items are seen as ways of enhancing the reliability of the quarterly reports. The discrete method should reduce, if not eliminate, the practice of using the fourth quarter as a ‘settling-up’ period. As at the time this was undertaken, the standard on interim reporting (in which the discrete method of reporting is recommended) was at its exposure draft stage. Therefore, in the absence of enforcement, companies may not take the proposal seriously. As previous literature has often associated the reliability of interim reports with auditor involvement, the obvious question that arises is: should external auditors be involved in the quarterly reporting of companies in Malaysia? This study is not suggesting that auditor involvement is necessary because the findings are insufficient to make such a recommendation. Moreover, auditor involvement requires a lost of cost and time. The trade-offs between costs and benefits, and timeliness and reliability should be taken into consideration. However, this study may provide an avenue for future research in the area of auditor involvement should the authoritative bodies consider auditor involvement with quarterly reporting in the future.

Table 7 shows the descriptive statistics of selected company characteristics (Panel A) and the results of Chi-square tests (Panel B). There is no evidence to suggest that the tendency for companies to defer the reporting of exceptional items is associated with the size, growth and leverage of a company. Nevertheless, this study provides evidence that non-profitable companies are more likely to defer the reporting of exceptional items to the final quarter than their profitable counterparts. The finding is significant at a 5 percent level.

Consistent with the results of previous studies and the earlier findings that most of the exceptional items reported in the final quarter tend to be negative, the current finding supports the ‘delay bad news’ theory or the notion that companies with poor performance may have a tendency to delay the release of bad news. The reliability of the first three quarterly reports of non-profitable companies is thus lower than that of the profitable ones.

TABLE 7
Descriptive Statistics and Chi-square Test Results

Panel A: Descriptive Statistics

	Mean (million)	Std. Dev. (million)	Median (million)	Min. (million)	Max. (million)
Total assets	1305.1410	2925.8360	459.8560	23.965	27,000.000
Profit margin	-0.6848	4.5869	0.0166	-47.910	0.600
Change in net sales	0.0846	1.4390	-0.0736	-0.850	14.420
Debt to total assets	0.3332	0.3343	0.2553	0	1.730

Panel B: Results of Chi-Square Tests

		Deferment of exceptional items				
		Not likely		Likely		Chi-Sq
		Frequency	Percentage	Frequency	Percentage	Sig.
Size:	Small	26	52	31	48.4	0.850
	Large	24	48	33	51.6	
Total		50	100	64	100	
Profitability:	Non-profitable	15	30	33	51.6	0.023*
	Profitable	35	70	31	48.4	
Total		50	100	64	100	
Growth:	Positive	28	56	42	65.6	0.335
	Negative	22	44	22	34.4	
Total		50	100	64	100	
Leverage:	Low	26	52	31	48.4	0.850
	High	24	48	33	51.5	
Total		50	100	64	100	

Note: *Significant at the 5% level.

7. CONCLUSION

This study found that greater incidence of exceptional items were reported in the fourth quarter than any other quarters. This supports the argument that companies use the fourth quarter as a settling-up period. The findings also provide the basis to believe that the quarterly reports are not always reliable. It is also interesting to observe that a majority of companies made negative adjustments during the fourth quarter. The 'delay bad news' theory is thus supported. This study also provides evidence that non-profitable companies are more likely to defer the reporting of exceptional items to the fourth quarter compared to profitable ones. There is no evidence of association between the deferment of the recognition of exceptional items and the size, growth, and leverage of a company.

In the absence of regulation on auditor involvement and enforcement of an accounting standard pertaining to interim reporting at the time this study was undertaken, the findings are expected. However, as auditor involvement is a time consuming and costly exercise, the trade-off between timeliness and reliability is a major concern. More studies are, however, required to justify the need for auditor involvement with quarterly reporting. As at the time of writing, *MASB 26* has been enforced; this, the use of the discrete method of reporting is expected to be widespread. To examine if *MASB 26* helps in encouraging the adoption of the discrete method and in enhancing the reliability of the quarterly reports, this study could be repeated.

The findings of the current study should warn investors that the quarterly reports are not always reliable, and not always prepared in line with some of the Islamic principles. Investors should treat income after exceptional items with caution because the recognition of the items may be deferred to the fourth quarter, in which the deferrals are likely to be negative. Because the findings of this study are limited to only companies that disclose exceptional items, generalization could not be made to all companies. Therefore, future research may adopt some other methods to determine the reliability of quarterly reports.

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