Should U.S. Companies Adopt Semi-Annual Reporting?
An Analysis of Quarterly Reporting Requirements and the Practice of Earnings Guidance

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Abstract

Quarterly reporting has been a central component of the U.S. equity markets since 1970. Recent statements by President Trump and an ongoing inquiry by the SEC have highlighted potential grievances with the current system. Critics believe that more frequent reporting incentivizes short-term thinking among management and investors. Similar criticism have been applied to the practice of earnings guidance. Yet, current reporting requirements have been attributed to greater transparency of information and a lower cost of capital for companies seeking to raise funds. This paper seeks to understand the sources of this disagreement. Using interviews of key actors from across the private and public sector, along with primary and secondary research, this paper finds that a bifurcated reporting system, whereby smaller companies would be allowed to report on a semiannual basis, is the best system to enhance long-term shareholder value. We also recommend that companies that issue earnings guidance should consider ending the practice, if appropriate.

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CHAPTER 1: INTRODUCTION

In the summer of 2018, Donald J. Trump sent waves throughout Wall Street when he expressed interest in changing current financial reporting requirements for publicly held U.S. corporations. The President suggested moving the current quarterly reporting system to semi-annual reporting. Such a change in policy would have a significant effect on a number of corporate stakeholders, ranging from investors to company executives. Supporters of the change argue that the current policy makes companies think in terms of short-term results rather than focusing on creating long-term value for their constituents. On the other hand, it is argued that a reduction in reporting frequency will alleviate companies from having to meet strict financial reporting requirements and would allow companies more time, albeit a relatively short three months, to development business plans that have a longer time frame, for example, the release of a new product. Conversely, institutional investors argue that any lessening of reporting frequency will limit their access to vital information needed to make informed and effective investment decisions.

By way of historical background, Trump noted his comments were inspired by outgoing Pepsi CEO Indra Nooyi, a member of the President's business forum. Nooyi reflected that during her time as an executive, quarterly reporting regulations made her pay undue attention on producing short-term results. This narrow time frame inhibits companies from enacting strategies and makes corporations more risk-averse. She commented, "Most agree that a short-term only view can inhibit long-term strategy, and thus long-term investment and value creation.[1]" By moving to a semi-annual reporting system, Nooyi believes corporations could establish a more feasible balance between short-term profits and long-term value creations. In

[1] Owusu, Tony. "Outgoing PepsiCo CEO Clarifies Position on Frequency of Financial Reports." *TheStreet*. TheStreet, 17 Aug. 2018. Web. 10 Oct. 2018.

addition, although moving to semi-annual reporting would be a departure from contemporary American policy, European companies have already established an effective standard for the practice. Nooyi went on to explain, “My comments were made in that broader context, and included a suggestion to explore the harmonization of the European system and the U.S. system of financial reporting. In the end, all companies have to balance short-term and long-term performance.[2]”

Bipartisan Support

Although the current conversation was started by President Trump, the idea has received bipartisan support in Washington. Democrats and Republicans seem to depart from their usual polarization when considering fostering long-term economic growth by altering the current practice. In a 2015 interview with the New York Review of Books, President Obama recognized that stockholders may unjustly penalize companies that focus on long-term value creation:

> Because they’ve got quarterly reports to shareholders and if they’ve made a long-term investment that may pay off way down the line, or if they’re paying their employees more now because they think it’s going to help them retain high-quality employees, a lot of times they feel like they’re going to get punished in the stock market. And so they don’t do it, because the definition of being a successful business is narrowed to what your quarterly earnings reports are.[3]

Hillary Clinton, who has been a vocal proponent for increasing transparency, voiced similar concerns over high frequency reporting when running for President. She feared companies sacrifice long-term health in favor of gimmicks that might artificially inflate stock

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[2] Owusu, Tony.

[3] Leaders, In Speaking to Business. "President Trump Asks SEC to Study Abolishing Quarterly Earnings Reports." *CNNMoney*. Cable News Network, 17 Aug. 2018. Web. 26 Nov. 2018.

prices in the short time, and promised reforms to "help CEOs and shareholders alike to focus on the next decade rather than just the next day.[4]"

History of Reporting Guidelines

Federal regulation of financial disclosures dates back to the Great Depression. In 1934, Congress passed the Securities and Exchange Act which created the Securities and Exchange Commission (SEC). The Act empowered the SEC to require the periodic reporting of publicly traded companies, although no formalized reporting schedule was established.[5] The SEC began to require semi-annual reporting in 1955. However, in 1970, the SEC moved to mandate quarterly reporting for all publicly traded U.S. companies.

In order to complement pre-existing regulation and provide greater transparency to shareholders, Congress passed the Sarbanes-Oxley (SOX) Act of 2002. Following major public scandals such as Enron, Congress sought to restore faith in the financial system. SOX sought to bolster investor confidence in publicly disclosed financial statements by requiring top-level management, specifically the CEO and CFO, to sign off on all major corporate disclosures, including, most importantly, a company's quarterly results on the SEC Form 10-Q. Prior to the enactment of the law, a company only had to certify its audited financials in its annual report, or Form 10-K. In addition, SOX mandated that companies and auditors institute internal controls to certify the quality of their financial reporting.[6] Overall, the legislation was designed to end, or at least limit, fraudulent reporting and held management accountable to the reports they were producing. The law also included punitive results for those executives for failure to fully comply with or be totally accurate with the financial results the company was reporting.

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[4] "Hillary Clinton Transcript: Building the 'Growth and Fairness Economy'." Blog post. *Wall Street Journal*. N.p., 13 June 2015. Web. 7 Oct. 2018.

[5] United States. U.S. Securities and Exchange Commission. *Sec.gov*. N.p., 1 Oct. 2013. Web. 20 Nov. 2018.

[6] Investopedia. "Internal Controls." *Investopedia*. Investopedia, 30 June 2018. Web. 19 Nov. 2018.

As briefly noted above, reporting requirements for U.S. public companies include a comprehensive annual report, the 10-K, which contains detailed financial information about the company, as well as a comprehensive management discussion and analysis and the signatures of all of the company's directors.[7] In addition, on a quarterly basis, companies file a 10-Q, which is largely similar in nature from a content perspective, however, an audit by an outside, independent auditing firm is not required, nor are directors required to sign the document. It has also become common practice that when companies issue a quarterly report, they frequently provide forward looking financial guidance as well, whereby companies project earnings for subsequent time periods. A change in reporting frequency will also likely alter the amount of guidance companies choose to disclose. It should be noted that companies who choose to provide forward looking information are often "protected" under the so-called "Safe Harbor Provision" that somewhat gives the company and its executives and directors a degree of protection from future litigations should the company not achieve the results that were forecast.

Methodology

In this paper, we hope to provide a comprehensive analysis of the impact of quarterly financial reporting and guidance and offer a policy recommendation that we think will provide the greatest utility to all stakeholders. In order to provide the most insightful recommendation, we have interviewed a number of investors, investment bankers, C-level executives, regulators and public relations experts, and have comprehensively reviewed the current literature in the field. We have evaluated both academic literature as well as leading financial news sources to develop our opinions.

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[7] Kennon, Joshua. "Annual Reports, 10-Ks, and 10-Qs and Looking for a Company Finances." *The Balance Small Business*. The Balance, n.d. Web. 21 Nov. 2018.

CHAPTER 2: THE BENEFITS OF THE QUARTERLY REPORTING SYSTEM

Greater Transparency

One of the strongest cases made in support of the current quarterly reporting system is that it increases transparency for investors. According to a study published by the Stanford Graduate School of Business, publicly available information is critical for price discovery. Information content released by companies has generally increased over time, and has been at the highest levels in recent years.[8] While the study fails to segment the sources of the information content among press releases, conference calls and analyst reports, it argues that investors have become accustomed to making investment decisions with a depth of information at their fingertips. When investors do not have access to quarterly financials, they become restless and sensitive to alternative news sources. An Indiana University study by Salman Arif and Emmanuel De George found that the "returns of semi-annual earnings announcers are almost twice as sensitive to the earnings announcement returns of U.S. industry bellwethers for non-reporting periods compared to reporting periods.[9]"

Information contained within the 10-Q may help investors better price risk into the stock price. Part I of the disclosure contains consolidated financials and management discussion on potential risks. Companies may opt to present non-GAAP measures, such as earnings per share diluted adjusted or adjusted free cash flow, to better present the core operating performance. Part II contains information on legal proceedings, unregistered sales of equity securities and defaults upon senior securities. This information may help investors identify companies on the verge of insolvency or illiquidity.

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[8] Beaver, William H., Maureen McNichols, and Zach Z. Wang. *Gsb.stanford.edi*. Stanford Business Graduate School of Business, 14 Mar. 2015. Web. 10 Nov. 2018.

[9] Arif, Salman and De George, Emmanuel T., Does Financial Reporting Frequency Affect Investors' Reliance on Alternative Sources of Information? Evidence from Earnings Information Spillovers Around the World (January 1, 2018). Kelley School of Business Research Paper No. 17-7.

Institutional investors, arguably more so than retail investors, rely upon 10-Q reports when analyzing historical performance and forecasting company performance. Recent SEC regulations have further strengthened this dependence on quarterly disclosures. Reg Fair Disclosure (FD), passed in 2000, sought to eliminate selective disclosure in which large institutions and industry insiders received material information before the general public, usually consisting of retail investors. The threat of prosecution under Reg FD has discouraged insider trading and cemented financial reports, disclosed or available widely to investors large and small, as the main source of information for investors.[10]

Greater disclosure may discourage fraud and illegal activities by companies. In the wake of major scandals in the early 2000's, the SEC approved numerous regulations to improve transparency in public equity markets. In 2002, Sarbanes-Oxley held company management responsible for the accuracy of quarterly and annual statements. Regulation AB, passed two years later, subjected asset-backed issuers to reporting requirements specifically tailored to their particular structure and operations.[11] A lineage of fraudulent practices by company management reminds us that regulations discourage, but cannot completely eliminate, the risk of illegal activity. The infamous case of Bernard L Madoff Securities, though not a publicly listed company, demonstrates this point. Madoff, who ran the largest ponzi scheme in history, sent monthly statements to clients and released annual audited reports, but was never detected by the government. This serves as a reminder that transparency does not solely refer to the quantity of reporting, but also the quality and clarity of material released.

A change to semi-annual reporting could entice company insiders to act on nonpublic information. As firms release less material information to the public, there are more

[10] Investopedia. "Internal Controls." *Investopedia*. Investopedia, 30 June 2018. Web. 19 Nov. 2018.
[11] United States. Securities and Exchange Commission. SEC Division of Corporate Finance. *Sec.gov*. N.p., 19 Nov. 2018. Web.

opportunities for and greater likelihood of insider trading. This is already observed in the market when analyst coverage of a company is reduced and insiders increase trading activity and experience an abnormal increase in returns.[12] Whether due to a reduction in analyst coverage or less frequent reporting, information asymmetry grows and so too do the benefits of private information.[13]

Lower Cost of Equity Capital

Greater transparency arguably leads to a lower cost of equity capital. Quarterly reporting allows investors to better understand the risks associated with companies, and thus expect a lower required return on equity. Transparency may be even more important for smaller companies that are capital-intensive, but are riskier than larger, blue-chips companies. This is not just implied by the capital markets theory, but echoed by the SEC in its 2016 report on Regulation S-K: "Additionally, because smaller, capital-intensive companies may need greater or more frequent access to capital markets, more frequent reporting may provide greater investor confidence and a lower cost of capital for these companies.[14]" According to an empirical study, the cost of public equity in the U.S. decreased between 1955 and 1970 as the SEC transitioned from a semi-annual to quarterly reporting requirement.[15] As companies report on a more frequent basis, investors can more appropriately price in risk and feel more confident about equity markets.

Companies trading on U.S. exchanges generally have a lower cost of capital relative to those on foreign exchanges.[16] At the end of October 2018, the S&P 500 Index was trading at

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[12] Dou, Winston and Ji, Yan and Reibstein, David and Wu, Wei, Customer Capital, Financial Constraints, and Stock Returns (March 12, 2018).

[13] "Pros and Cons of Quarterly Reporting: Summary of Key Issues." N.p., 29 Aug. 2018. Web. 18 Nov. 2018.

[14] *Business and Financial Disclosure Required by Regulation S-K.* Rep. Washington, DC: Securities and Exchanges Commission, 2017. Print.

[15] Fu, Renhui and Kraft, Arthur Gerald and Zhang, Huai, Financial Reporting Frequency, Information Asymmetry, and the Cost of Equity (July 10, 2012). Journal of Accounting & Economics (JAE) 54 (2012): 132–149.

[16] Krauskopf, Lewis. "Kill Quarterly Reporting? Some Investors Ring Alarm Bells." *Reuters*. Thomson Reuters, 17 Aug. 2018. Web. 5 Nov. 2018.

22.23 times earnings for the past twelve months[17] compared to 14.6 times for the STOXX Europe 600 Index.[18] This can be partially attributed to extensive reporting requirements and stringent regulations by the SEC and FINRA. In a testimony to the U.S. Senate Banking Committee, CBOE Global Markets Board Member Joe Ratterman praised U.S. public equity markets as the most "liquid, transparent, efficient, and competitive . . . in the world.[19]" U.S. markets are far from perfect but still held in high regard on the global stage.

[17] "S&P 500 PE Ratio by Month." *US Population by Year*, www.multpl.com/table?f=m.

[18] Stoxx Europe 600 Index. Stoxx , 2018, Stoxx Europe 600 Index,www.stoxx.com/document/Bookmarks/CurrentFactsheets/SXXGR.pdf.

[19] United States Securities and Exchange Commission. *U.S. Equity Market Structure: Making Our Markets Work Better for Investors*. *Sec.gov*. N.p., 11 May 2015. Web. 12 Nov. 2018.

CHAPTER 3: ISSUES WITH THE QUARTERLY REPORTING SYSTEM

Fosters Short-Term Thinking

While quarterly reporting affords investors greater transparency and allows companies to raise funds more cheaply, it may entice management to sacrifice long-term strategy for short-term gains. In contrast, a semi-annual reporting system would arguably shift management focus towards long-term value creation and lift the stress of comparing company performance every three months. Critics of the current system range from ranking politicians to high-profile investors and company executives.

In some cases, companies seek to go private in an attempt to escape the barrage of reporting requirements. In his August 2018 email to employees, Elon Musk justified his attempt to take Tesla private: "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.[20]" Musk told his employees that his other company, SpaceX, is far more operationally efficient than Tesla since it is privately owned and not burdened by the quarterly earnings cycle. The short-term thinking of markets may clash with Tesla's long-term mission, he opined.

Following private equity firm JAB's $7.5 billion acquisition of Panera Bread in a leveraged buyout, Panera's CEO Ron Shaich, described the flexibility that being private affords. In April 2017, he told CNBC's *Squawk on the Street,* "What is hard for me is the continual pressure on the short term. When I started 25 years ago, I will tell you that a third of our investors were looking at this [investment] for a year longer. Today, I will tell you two-thirds of

[20] Tesla. *Taking Tesla Private*. *Tesla.com*. N.p., 7 Aug. 2018. Web. 1 Nov. 2018.

our investors are thinking literally quarter to quarter."[21] From Shaich's perspective, focusing too much on the short term has harmed the brand in the past. He praised JAB, not just for potential revenue synergies down the line, but for its commitment to Panera Bread's long-term future. Though it has not been empirically proven, many business executives attribute fewer reporting requirements, and consequently an emphasis on the long-term, as a main reason private companies outperform public ones. Since 2000, the number of active private equity firms has increased by 143% and global private equity deal volume has increased by 568%.[22] PE has become an avenue of choice for many companies, and institutional investors.

Quarterly reporting has also created a culture in which firms release quarterly guidance. As with reporting, the practice of guidance has benefits, but also drawbacks. The pros and cons of earnings guidance will be discussed in greater detail in Chapters 5 and 6, respectively. The implementation of a semi-annual reporting system may encourage firms to issue guidance over a longer time horizon or dissuade them from issuing expectations altogether. Kathryn Cearns, member of the Institute of Chartered Accountants in England and Wales (ICAEW) Council and the International Monetary Fund (IMF) External Audit Committee, noted that the switch from quarterly to semi-annual reporting in the UK in turn addressed issues with the practice of issuing guidance.[23]

Cost of Compliance

The SEC has a three-part mission: protect investors, maintain orderly and efficient markets, and facilitate capital formation.[24] The agency must ensure markets have an appropriate

[21] Whitten, Sarah. "After a $7.5 Billion Deal, Panera's CEO Says He Can Do Even More as a Private Business." *CNBC*. CNBC, 05 Apr. 2017. Web. 23 Nov. 2018.
[22] "The Rise and Rise of Private Markets." McKinsey & Co.
[23] Interview with Kathryn Cearns, 13 Nov. 2018.
[24] United States. Securities and Exchange Commission. *The Role of the SEC*. N.p.: n.p., n.d. Print.

amount of information without creating reporting burdens that jeopardize the efficiency of our markets. Reporting places a time and monetary cost on companies.

Based upon conversations and data from executives at several large companies, the out-of-pocket, cash expenses for quarterly reporting could be as high as $100,000 a reporting period. This cost includes the fees to outside lawyers, auditors, tax experts, IR/PR consultants, and service providers such as Business Wire. Of course, the expenses would vary greatly as circumstances warrant. For example, if a particular quarter includes extraordinary or one-time non-operating charges or gains, such as an insurance or litigation settlement, the cost to comply would be greater due to the complexity in the accounting and explaining the incident.

It was also pointed out that the fourth quarter, the year-end period, would also be more expensive since that is the audited period and many more items are included in this reporting period. The cost of compliance for the fourth quarter/annual results could be more than, or even double, the costs incurred during each of the prior three quarters.

These costs may be easily absorbed by larger companies, but can amount to a nontrivial amount (as a percent of revenue) for smaller firms. An analysis conducted by consulting firm Audit Analytics for *The Wall Street Journal* found that accelerated and large accelerated filers (which have issued over $75 million and $700 million of stock to the public, respectively) paid audit fees of $541 per $1 million of revenue to independent auditors in 2016, or 0.05 percent of revenue. Smaller companies, based on a sample of 1,554 firms, paid $3,345 per $1 million of revenue, or 0.33 percent of revenue. These fees are paid in relation to both quarterly and annual filings, but the discrepancy based on size is alarming. For smaller firms, absolute costs represent a significantly larger portion of potential profit.[25]

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[25] Shumsky, Tatyana. "Move to Semiannual Reporting Would Benefit Small Companies the Most." *The Wall Street Journal*, Dow Jones & Company, 4 Sept. 2018, www.wsj.com/articles/move-to-semiannual-reporting-would-benefit-small-companies-the-most-1536053400.

The Audit Analytics study solely focused on the costs involved with performing an audit, and does not include fees associated with internal and external lawyers, public relations firms and in-house finance teams. Matthew Kreps, Managing Director at Darrow Associates, an investor relations firm focused on small and micro-cap businesses, noted that for small cap equity, the "dollar cost [from quarterly reporting] can be a disproportionate amount of OPEX spent on the SG&A line."[26] A small cap media company, which requested anonymity, with annual revenue of approximately $500 million, found that it would save ~0.05 percent of annual revenue under a semi-annual reporting system, excluding time spent by senior management on quarterly filings. These potential savings represents capital that could be reinvested annually back in to the business to fuel growth.

Finally, all of these expenses are to advisers to the company and do not take into account the time of the company's own staff, from the CEO, CFO, accounting, legal and communications personnel. The Executive Chairman of the aforementioned small cap media company believes that the time spent on quarterly filings is certainly "non-trivial" and a bigger drain on the company than the dollar cost itself. He gauges that the CEO and CFO spend 2 percent and 5 percent of their annual time on quarterly filings, respectively.[27] A 2017 study by PricewaterhouseCoopers concluded that it takes most companies four and a half days to close their books for the quarter. While this is down from six days in 2009 due to improved technology, it still represents a significant amount of time.[28] However measured, it is fair to say that the cost of quarterly reporting is expensive, and as new rules and regulations have made compliance more difficult, these expenses have risen as well.

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[26] Interview with Matt Kreps, 7 Dec, 2018.

[27] Interview with CEO of small cap media company, Dec 7, 2018.

[28] Shumsky, Tatyana. "Technology Speeds Up Timeline on Quarterly Close." The Wall Street Journal, Dow Jones & Company, 14 Aug. 2017, www.wsj.com/articles/technology-speeds-up-timeline-on-quarterly-close-1502708402?mod=article_inline.

CHAPTER 4: THE BENEFITS OF QUARTERLY GUIDANCE

Earnings guidance is a common practice in the U.S. in which companies voluntarily disclosure performance forecasts for the next quarter or year. In 2016, 27.8 percent of S&P 500 companies issued quarterly guidance, giving a specific earnings per share figure for the next quarter. The same year, 31.4 percent of S&P 500 companies released annual guidance, typically updating estimates on a quarterly basis, a practice known as providing a “rolling forecast.[29]” This section discusses reasons companies choose to report quarterly earnings results. Proponents of the practice believe that short-term guidance improves the accuracy of analyst reports, and increases transparency. Moreover, in industries in which guidance is the status quo, there may be a first mover disadvantage for abandoning guidance.

Wall Street Expectations

Buy and sell-side analysts will speculate on next quarter earnings for a company, regardless of whether the company releases official earnings guidance. CNBC financial columnist Bob Pisani told his readers, “if companies don’t set goals, Wall Street will.[30]” Company forecasts may be more reliable than those produced by the Street. A study of 27,000 guidance reports found that company managers could better predict future company performance than Wall Street analysts.[31] This implies that stock prices would be more efficient when management issues guidance.

When a company’s public industry peers are all providing earnings guidance, it is a challenge to deviate from the crowd and end the issuance of guidance.[32] According to Jim

[29] "Warren Buffett and Jamie Dimon Really Want Companies to Stop Giving Quarterly Earnings Guidance." *Fortune*. Fortune, 7 June 2018. Web. 18 Nov. 2018.

[30] Pisani, Bob. "Ending Quarterly Earnings Guidance Won't Solve the Issue of 'short-term' Thinking." CNBC. CNBC, 07 June 2018. Web. 21 Nov. 2018.

[31] Epstein, Gene. "A Misguided Strategy." Editorial. *Wall Street Journal* 19 Feb. 2007: n. pag. Web.

[32] Kekst & Company. *Revisiting: To Guide or Not to Guide? Report. New York, New York: Kekst & Company, 2009.* N.p., Feb. 2006. Web. 1 Oct. 2018.

Fingeroth of Kekst & Co., a preeminent investor relations and corporate communications counseling firm, if earnings guidance is the standard within an industry, company management may be hesitant to discontinue guidance and "abandon ship." Fingeroth notes that companies with comparative advantages or unique characteristics are in a "league of their own" and may be less affected by this first mover disadvantage.

Increased Publicity

Firms that issue guidance tend to have greater analyst coverage.[33] According to a comprehensive study by Houston, Tucker, and Lev, firms that do not issue guidance are covered by fewer analysts, had weaker profits, and struggled to meet Street expectations[34]. With less information on a company, analyst projections varied more and began to deviate more from actual results.[35]

[33] Kekst & Company.

[34] Houston, Joel F. and Lev, Baruch Itamar and Tucker, Jenny Wu, To Guide Or Not to Guide? Causes and Consequences of Stopping Quarterly Earnings Guidance (May 22, 2008). Contemporary Accounting Research, Vol. 27, No. 1, 2010.

[35] Epstein, Gene.

CHAPTER 5: THE ISSUES WITH QUARTERLY GUIDANCE

Much discussion has centered around the practice of earnings guidance and its perpetuation of short-term thinking in U.S. public equity markets. The following section discusses the criticisms of quarterly earnings guidance with respect to long-term value creation.

Fosters Short-Termism

As with quarterly reporting, quarterly earnings guidance may foster a culture of short-term thinking at the expense of long-term value creation. BlackRock CEO and Chairman Larry Fink sums up this issue: "Today's culture of quarterly earnings hysteria is totally contrary to the long-term approach we need."[36] Fink has been a vocal critique of quarterly guidance, and believes the practice does not contribute to long-term value creation.

Management may make inefficient or unwise decisions at the end of quarter to meet Street guidance. Bob Lutz, former Vice Chairman of General Motors, states that the "search for quarterly earnings is the father of many, many bad product decisions.[37]" Lutz mentions that automobile companies may increase daily rentals of its cars to meet earnings guidance and post stronger quarterly results.[38] Rental revenues increase, but the residual value of cars falls and so do margins. Companies may also oversupply luxury cars and discount prices to improve quarterly results. In fact, nearly 40 percent of executives said they would give discounts to clients to spur spending in the current quarter to meet guidance.[39] Not only are steep markdowns unsustainable, but they can tarnish the brand's image and weaken future pricing power.

Companies can manipulate accounting and engage in controversial practices when quarterly performance lags. Lutz stresses the issue of channel stuffing, an illegal practice in

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[36] Villanova, Patrick. "Making Sense Of The Quarterly Reporting Muddle." *Forbes*. Forbes Magazine, 14 Nov. 2018. Web. 20 Nov. 2018.
[37] Interview with Bob Lutz, 14 Nov. 2018.
[38] Interview with Bob Lutz.
[39] Graham John R., Campbell A. Harvey and Shiva Rajgopal, "The economic implications of corporate financial reporting," Journal of Accounting and Economics, Volume 40, pp. 3–73, 2005

which companies ship surplus inventory to retailers and distributors to temporarily increase firm's accounts receivables and inflate top line growth.[40] Pressured by short-term expectations, companies may be enticed to "cook the books" to deceive investors and tell a different story on paper than in reality.

Short-term thinking discourages companies from reinvesting sufficient amounts of capital into the business. Companies that guide on a consistent basis have been shown to invest 10 percent less on research and development each year.[41] Human capital, equipment, and research and development are neglected, consequently restricting growth potential. Studies conclude that management prioritizes quarterly performance, even when potential investment opportunities have positive NPV and strategic value. A 2016 McKinsey and FCLTGlobal survey found that 60 percent of executives would delay projects and 80 percent would cut discretionary funding in order to meet the short-term earnings expectations of the investor.[42]

Share buybacks are one way in which companies can reduce the number of outstanding shares to boost per-share earnings. A company is more likely to repurchase stock when it allows a company to surpass the EPS forecast.[43] These repurchases are associated with a reduction in employment and investment, a tradeoff management seems to willing make in order to meet quarterly expectations.[44] Moreover, a 2014 study in the *Harvard Business Review* by William Lazonick found that the rise in equity compensation for senior executives spurred open market purchases[45]. Managers become more determined to meet pre-established earnings targets, especially when a drop in stock price directly affects pay. This is not to say that share buybacks

[40] Interview with Bob Lutz.

[41] Cheng, Mei, K.R. Subramanyam and Yuan Zhang. "Earnings guidance and Managerial myopia." October 2007

[42] Babcock, Ariel Fromer, and Sarah Keohane Williamson. Moving Beyond Quarterly Guidance: A Relic of the Past. Rep. Boston: FCLT Global, 2017. Print.

[43] Heitor Almeida, Vyacheslav Fos, Mathias Kronlund, The real effects of share repurchases, Journal of Financial Economics, Volume 119, Issue 1, 2016, Pages 168-185.

[44] Heitor Almeida et al.

[45] Lazonick, William. Profits Without Prosperity. Rep. N.p.: Harvard Business Review, 2014. Web.

are always antithetical to long-term growth. Buybacks offer a reasonable investment opportunity for companies with residual cash after investment and a lack of alternative growth opportunities.

Unpredictability

One must also consider the psychological component behind guidance. Ari Gabinet, Adjunct Lecturer in International and Public Affairs at Brown University, believes management is honest for the most part, but that providing guidance allows numbers to be massaged (legally) to ease investors to a soft landing or pump up stock price.[46] Guidance is speculative and not standardized, with the personalities and personal belief of management influencing results. Risk-averse management and board would more likely prefer to release estimates on the lower side; thus the company can "beat" Wall Street estimates when results are released and lead to a "pop to the stock." The presence of whisper numbers, which refer to unofficial and unpublished earnings per share forecasts among finance professionals, can confuse markets and undermine the integrity of the CFO. Moreover, factors outside the company's control can affect future performance. It is difficult for companies to correctly account for future macroeconomic conditions, cultural trends and changes to cost of goods sold which are unpredictable and have a significant impact on earnings.

The Private Securities Litigation Reform Act of 1995 (PSLRA) protects management issuing forward looking statements in the case that actual results differ from estimates.[47] Gabinet views the safe harbor as tremendously important in protecting management from lawsuits from

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[46] Interview with Ari Gabinet, 7 Nov, 2018.

[47] "Private Securities Litigation Reform Act of 1995 (PSLRA)." *Practical Law US Signon*, content.next.westlaw.com/Document/Ic20f1a48061f11e598db8b09b4f043e0/View/FullText.html?contextData=%28sc.Default%29&transitionType=Default&firstPage=true&bhcp=1.

disappointed investors.[48] The safe harbor does not protect management who knowingly issue misleading guidance, though this is hard to prove.

Accountability

While analysts and the media still pay close attention to quarterly performance and earnings guidance, investors have begun to place less weight on such metrics. In a 2006 CFA study of institutional buy-side investors, 76 percent of respondents expressed a desire for companies to move away from quarterly earnings guidance.[49] More than ten years later, the Rivel Research Group Intelligence Council came to a similar conclusion when it found that just nine percent of investors considered earnings guidance (for periods less than a year) as an important factor to consider. Shareholders have become more long term oriented, with 70 percent of shares held by long-term investors.[50] Investors for the most part do not use quarterly results to evaluate management and company performance.

[48] Interview with Ari Gabinet
[49] Babcock et al.
[50] Babcock et al.

CHAPTER 6: RECOMMENDATION

There are benefits and drawbacks to the current quarterly reporting system in the United States. On the positive side, quarterly reporting increases transparency and reduces the cost of capital. It has long been argued that investors can better price in risk and growth trends, and deter fraudulent practices if companies provide information on a more frequent basis. In the words of one Wall Street veteran, " the more information you put out and with more frequency means that you have lessened the occasion for sin." While this bromide sounds logical, experience has shown that this is not always the case. What is more clear is that quarterly reporting fosters a culture of short-term thinking and places a cost burden on companies, especially smaller ones.

The current system is far from perfect, but comparisons with the UK suggest that a change is not necessary at this time for mid-cap and large-cap companies. Robert Pozen's 2017 study on the UK found that the transition to quarterly reporting in the UK did not lead to an increase in re-investment.[51] In addition, critics of quarterly reporting tend to note that quarterly reporting encourages firms to release quarterly, or rolling, guidance. Cearns attributes the association between quarterly reporting and guidance as one of the main reasons the UK replaced quarterly reporting. The number of firms issuing earnings guidance in the U.S. has generally decreased over the past five years, even as quarterly reporting and stringent requirements remain in place. In 2016, only 27.8 percent of S&P 500 firms issued quarterly earnings guidance, down from 36.0 percent in 2010 (FIGURE 1). While the removal of quarterly reporting to discourage guidance may have been more appropriate in the UK, it does not seem obligatory in the US.[52]

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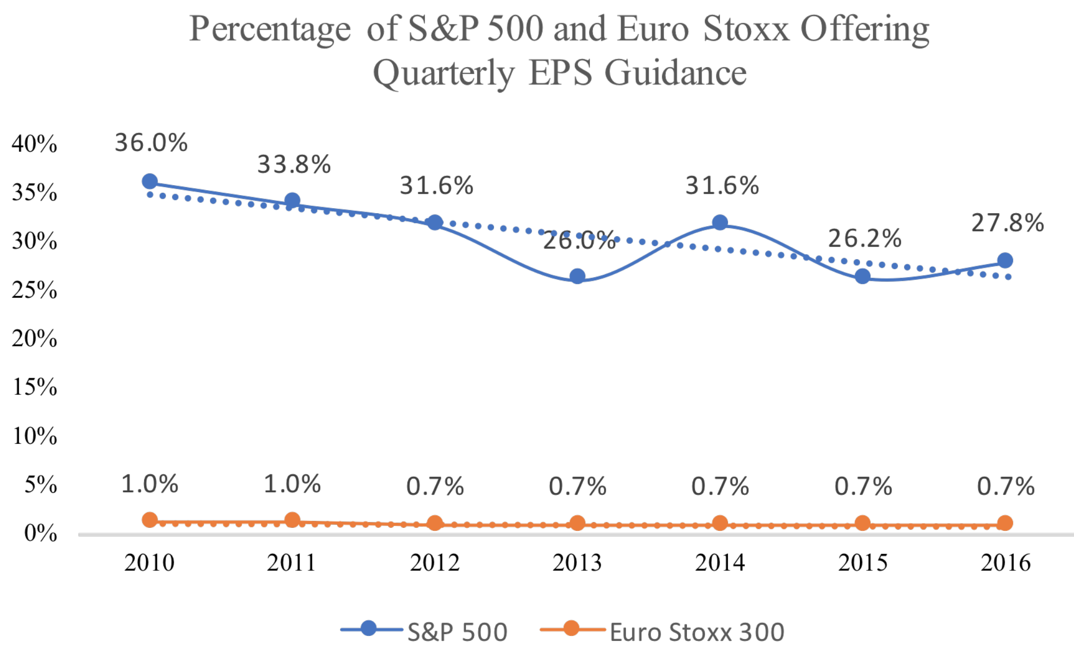
[51] Pozen, Robert and Nallareddy, Suresh and Rajgopal, Shivaram, Impact of Reporting Frequency on UK Public Companies (March 1, 2017). CFA Institute Research Foundation 2017B - 1; Columbia Business School Research Paper No. 17-59.

[52] Babcock et al.



(Figure 1[53])

We would suggest that a mid-ground might make sense: adopting a bifurcated reporting system appropriately addresses the major issues with quarterly reporting for small-cap companies, but holds mid and large cap companies to the current reporting regimen. Under such a system, smaller sized companies would be allowed to report on a semi-annual basis, while mid and larger businesses would continue to disclose quarterly. The higher cost of compliance for smaller companies compared to larger ones (as a percentage of revenue) leads to an asymmetric impact on capital expenditures and reinvestment. Quarterly reporting is a negligible cost for large cap companies, but has been shown to adversely impact smaller businesses from both a monetary and time perspective. Reduced reporting requirements would allow small-cap company executives to spend less time on quarterly filings and more on projects that maximize long-term

[53] Babcock et al.

shareholder value. In addition, cost savings from semi-annual reporting can be allocated towards projects that unlock long-term shareholder value.

In October 2018, SEC Chairman Jay Clayton confirmed that quarterly reporting will remain in place for larger companies, but has yet to address smaller businesses.[54] The SEC is currently exploring the possibility of a bifurcated reporting system. This inquiry follows a string of studies over the past several years to improve the efficiency of financial regulations. Recent legislation shows a willingness by Congress and the SEC to ease compliance requirements for smaller companies when appropriate. The 2012 Jobs Act reduced filing requirements for "emerging growth companies" with less than $1 billion in total annual gross revenue in the most recent fiscal year.[55] Even if the current SEC probe does not lead to a change in reporting requirements, it has recast this important issue back into the public spotlight.

One must also consider how companies should be grouped, whether based on market capitalization, profit or revenue. Since the 2012 Jobs Act differentiated between company size based on annual revenue for the fiscal year, this seems to be the most feasible choice.[56]

A proposed bifurcated reporting system would surely be met by opposition. Ken Langone, a vocal critic of quarterly earnings guidance and today's emphasis on short-term thinking, believes that the current reporting system will stay in place. In his eyes, a bifurcated system is not a suitable solution as the SEC would be "trying to play God." Langone is among the majority who believe that a "one size must fit all" when it comes to reporting disclosures. Pozen too refutes a bifurcated system, noting that the division would reduce liquidity of trading

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[54] Bain, Benjamin. "Big Firms' Quarterly Reporting Unlikely to Change 'Anytime Soon,' SEC Chief Says." *Bloomberg.com*, Bloomberg, 11 Oct. 2018, www.bloomberg.com/news/articles/2018-10-11/less-frequent-profit-reports-won-t-happen-soon-sec-chief-says.

[55] United States. SECURITIES AND EXCHANGE COMMISSION. *Emerging Growth Companies*. N.p.: n.p., n.d. Web.

[56] "Jumpstart Our Business Startups (JOBS) Act." *SEC Emblem*, 1 Feb. 2017, www.sec.gov/spotlight/jobs-act.shtml.

markets for smaller companies and raise the cost of capital.[57] This is a valid concern, and one that requires further empirical research before a bifurcated system should be implemented in the U.S.

Like reporting, quarterly earnings guidance serves to increase transparency and aid investors in identifying attractive investment opportunities. Yet, there is strong evidence indicating that guidance has perpetuated short-term thinking. An overwhelming majority of empirical evidence finds that the issuance of guidance, and the subsequent pressure to surpass expectations, blinds management from seeing the bigger picture. Discretionary spending, research & development, employment all fall when management is pressed to make earnings. Lutz expands on these finds when pointing out that the damage to brand image from these poor decisions is hard to quantify, but detrimental to revenue growth potential.

While much of our analysis and public research on this topic has focused on quarterly earnings guidance, the key points can be applied to annual earnings guidance. While annual guidance concerns the next four quarters, it is typically updated on a rolling basis and thus places management in a similar position.

There is no "one size fits all" solution when it comes to earning guidance. Some companies may be able to balance short-term guidance with long-term performance. However, for companies with long operating cycles, such as construction or energy businesses, quarterly guidance can be quite distracting.

Instead of giving a concrete earnings per share estimate, companies can share key performance indicators (KPI) that serve as milestones for a company's progress and reflects how well a company accomplishes key business objectives. For example, Facebook releases estimates for daily active users (DAU), monthly active users (MAU), and average revenue per user

[57] Pozen, Robert and Nallareddy, Suresh and Rajgopal, Shivaram.

(ARPU). Not only do these indicators better express the performance of Facebook than the traditional EPS estimate, but Facebook expresses them over three different time horizons: 3 year, 5 year and 10 year. Management should tailor guidance to best express the operations of the company.[58]

This paper is intended to provoke a discussion on a topic that is critical to the American capital markets and the ability of U.S. companies, primarily those whose share trade on exchanges in America. We have tried to balance the pros and cons of quarterly reporting by addressing issues that are currently being considered by top officials in government and regulators. In the end, like so many complex issues, compromises will have to be made, especially if we wish to encourage companies, large and small, to grow and prosper for all of their stakeholders.

[58] Babcock et al.

APPENDIX

List of Interviews Conducted:

Ari Gabinet, Brown University Adjunct Lecturer in International and Public Affairs

Bob Lutz, Former Vice-Chairman of General Motors

Director of Media Relations for Large Cap Technology Company (Requested Anonymity)

Executive Chairman of Small Cap Media Company (Requested Anonymity)

Jim Fingeroth, Executive Chairman, Kekst & Co.

Kathryn Cearns, Member of the ICAEW Council and IMF External Audit Committee

Ken Langone, Co-Founder, Home Depot

Matthew Kreps, Managing Director, Darrow Associates Investor Relations

Ward Nye, Chairman, President and CEO, Martin Marietta Materials

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