QUARTERLY REPORTS QUALITY: EVIDENCE FROM EARNINGS DEVIATION BETWEEN AUDITED ANNUAL FINANCIAL STATEMENTS AND CUMULATIVE QUARTERLY REPORTS

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LIST OF ABBREVIATIONS

AMEX	:	American Stock Exchange
APB	:	Accounting Principles Board Opinion
DSOP	:	Draft Statement of Principle
ERC	:	Earnings Response Coefficients
EU	:	European Union
FASB	:	Financial Accounting Standards Board
FRS	:	Financial Reporting Standards
GAAP	:	Generally Accepted Accounting Principles
IAS	:	International Accounting Standards
IASB	:	International Accounting Standards Board
IASC	:	International Accounting Standards Committee
IFR	:	International Financial Reporting Standards
KLSE	:	Kuala Lumpur Stock Exchange
LSE	:	London Stock Exchange
MASB	:	Malaysian Accounting Standards Board
MFRS	:	Malaysian Financial Reporting Standard
NYSE	:	New York Stock Exchange
OLS	:	Ordinary Least Square
SEC	:	Securities and Exchange Commission
SET	:	Stock Exchange of Thailand
SGX	:	Singapore Exchange
UK	:	United Kingdom
US	:	United States of America

KUALITI PELAPORAN SUKU TAHUNAN: PEMBUKTIAN DARIPADA PERBEZAAN KEUNTUNGAN ANTARA PENYATA KEWANGAN TAHUNAN DIAUDIT DAN PELAPORAN SUKU TAHUNAN TERKUMPUL

ABSTRAK

Banyak negara mengkehendaki syarikat tersenarai untuk menerbitkan akaun suku tahunan. Objektifnya ialah untuk menyediakan maklumat yang lebih tepat pada masanya. Walaubagaimanapun, kebimbangan terhadap kualiti akaun tersebut seringkali dibangkitkan kerana tidak perlu diaudit. Tujuan kajian ini adalah untuk memeriksa kualiti akaun suku tahunan berdasarkan perbezaan keuntungan antara akaun tahunan diaudit dan akaun suku tahunan terkumpul. Sampel adalah berdasarkan kesemua syarikat tersenarai di Bursa Malaysia pada tahun 2000 sehingga 2012 yang terdiri daripada 10,791 pemerhatian. Ujian *T*, *Pearson Chi-square*, kolerasi *Pearson* dan regresi *Ordinary Least Square* digunakan untuk menguji hipotesis-hipotesis. Penemuan menunjukkan bahawa keuntungan tahunan diaudit adalah berbeza daripada keuntungan perjumlahan suku tahunan. Hampir 61 peratus syarikat mempunyai perbezaan keuntungan dan hampir 59 peratus daripada syarikat tersebut mempunyai keuntungan terlebih catat. Magnitud perbezaan keuntungan syarikat keuntungan terlebih catat adalah lebih tinggi daripada syarikat perbezaan keuntungan terkurang catat. Dengan itu, keputusan menunjukkan bahawa akaun suku tahunan yang dihasilkan oleh syarikat tersenarai di Malaysia adalah berkualiti rendah, dimana cenderung untuk terlebih catat keuntungan. Sementara itu, magnitud perbezaan keuntungan ditemui berkolerasi dengan prestasi keuntungan. Walaupun syarikat perbezaan keuntungan terlebih catat tidak mempunyai prestasi keuntungan yang rendah, tetapi syarikat perbezaan keuntungan terkurang catat

mempunyai prestasi keuntungan yang lebih tinggi berbanding syarikat lain. Magnitud perbezaan keuntungan berkaitan tersalah nyata adalah lebih tinggi daripada yang berkaitan peristiwa selepas tempoh pelaporan. Keputusan mencadangkan bahawa kewujudan perbezaan keuntungan adalah bukti kualiti akaun suku tahunan yang rendah dimana cenderung kepada tersalah catat daripada peristiwa selepas tempoh pelaporan dan lebih berkaitan manipulasi daripada kesilapan. Walaubagaimanapun, selepas penggunaan kaedah diskret pada tahun 2002, magnitud perbezaan keuntungan dan kekerapan syarikat perbezaan keuntungan terlebih catat telah berkurangan, tetapi kekerapan syarikat perbezaan keuntungan terkurang catat telah meningkat. Ini menunjukkan bahawa penggunaan kaedah diskret meningkatkan kualiti akaun suku tahunan. Sementara itu, analisis regresi *OLS* terhadap keuntungan suku tahunan yang diterbitkan pada tahun 2012 menunjukkan syarikat tanpa perbezaan keuntungan mempunyai pekali reaksi keuntungan yang lebih tinggi daripada syarikat perbezaan keuntungan. Syarikat perbezaan keuntungan terkurang catat mempunyai pekali reaksi keuntungan yang lebih tinggi daripada syarikat perbezaan keuntungan terlebih catat. Keputusan mencadangkan bahawa pelabur meletakkan kebolehpercayaan yang rendah terhadap keuntungan suku tahunan yang dihasilkan oleh syarikat perbezaan keuntungan. Pelabur juga menilai jenis perbezaan keuntungan. Keseluruhannya, kajian ini menambah kepada literasi yang semakin meningkat berkaitan kualiti akaun suku tahunan dan pekali reaksi keuntungan. Ia juga meningkatkan kefahaman terhadap tingkah laku pengurusan, juruaudit dan pelabur. Dapatan mencadangkan keperluan usaha secara berterusan bagi meningkatkan kebolehpercayaan akaun suku tahunan, mungkin dengan cara semakan oleh juruaudit.

QUARTERLY REPORTS QUALITY: EVIDENCE FROM EARNINGS DEVIATION BETWEEN AUDITED ANNUAL FINANCIAL STATEMENTS AND CUMULATIVE QUARTERLY REPORTS

ABSTRACT

Many countries have required listed companies to publish quarterly accounts. The objective is to provide more timely information. However, concern has been raised on the quality of the accounts since they are not required to be audited. The purpose of this study is to examine the quality of quarterly accounts based on the earnings deviation between audited annual accounts and cumulative quarterly accounts. Sample is based on all companies listed on the Bursa Malaysia between year 2000 to year 2012 which consists of 10,791 observations. The T-test, Pearson Chi-square, Pearson correlation and Ordinary Least Square regression analyses are used to examine the hypotheses. It is found that audited annual earnings deviates from cumulative quarterly earnings. Almost 61 percent of companies have earnings deviation and almost 59 percent of these companies have overstated quarterly earnings. The magnitude of the overstated earnings deviation companies is higher than those of the understated earnings deviation companies. Thus, the results suggest a sub-standard quality of quarterly accounts produced by listed companies in Malaysia, where companies tend to overstate their quarterly earnings. Meanwhile, the magnitude of earnings deviation is found to be correlated with earnings performance. Even though, overstated earnings deviation companies do not have lower earnings performance, but understated earnings deviation companies have higher earnings performance than other companies. The magnitude of earnings deviation related to misstatements is higher than those related to events after reporting period. The results imply that the occurrence of earnings deviation is evident of low quality quarterly accounts, whereby it is more related to misstatements rather than events after reporting period and is more related to manipulation rather than errors. However, after the application of the discrete method in 2002, the magnitude of earnings deviation and the frequency of overstated earnings deviation has decreased, but the frequency of overstated earnings deviation companies has increased. This implies that the use of discrete method enhances the quality of quarterly accounts, partly. Meanwhile, the OLS regression analysis of the quarterly earnings published in 2012 shows that companies without earnings deviation have higher earnings response coefficient than companies with earnings deviation. Understated earnings deviation companies have higher ERC than overstated earnings deviation companies. Results suggest that investors presume lower reliability on quarterly earnings produced by earnings deviation companies. Investors also do value the type of earnings deviation. Overall, this study adds to the growing literature on the quality of quarterly accounts and earnings response coefficient. It also enhances the understanding on behaviour of management, auditors and investors. Findings suggest the need of continuous efforts to enhance the reliability of quarterly accounts, perhaps by requiring auditors' review.

CHAPTER ONE
INTRODUCTION

1.0 Introduction

The quality of financial reporting has always been a major concern not only to shareholders but also to creditors, regulators and researchers. This is because financial reporting is a major mechanism in dissemination of asymmetry information between the managers and these parties (Whittington, 1993). The information is later used in the economic decision-making process (Lev & Ohlson, 1982; Penno, 1985) and therefore, lack of quality in financial reporting may mislead users' judgments.

Traditionally, financial reporting for external users is prepared on an annual basis. Annual reporting provides the most comprehensive and reliable source of financial information. However, it suffers from timely problem, whereby some of the information provided by the reports may become irrelevant at the time of production. To overcome this timely problem, interim reporting is required, but its credibility may be questionable as it is not required to be audited.

Quarterly financial reporting is one type of interim reporting. The quarterly accounts which are prepared for a period of three months are required to disseminate a more timely information and thus, allows for more regular monitoring by the interested parties. However, since the quarterly accounts are usually not audited, the quality of these accounts has become a concern (see for example Ibrahim, Raman & Saidin, 2009; Ismail & Abdullah, 2009; Yang & Krishnan, 2005). Unaudited quarterly accounts expose the accounts to the risk of accounting errors and manipulations by the managers (Ismail & Chandler, 2005a). Recent concerns by regulators on financial reporting quality have been focusing on quarterly accounts (Yang & Krishnan, 2005).

An earlier study by Ibrahim et al. (2009) had reported the occurrence of earnings deviation between cumulative quarterly accounts and audited annual accounts by a majority of listed companies on the Bursa Malaysia. The occurrence of the deviation between these two accounts may suggest that the quarterly accounts produced are inaccurate and the users who rely on these accounts may make wrong decisions. However, the occurrence of the deviation may also be due to adjustments of events which occur after the production of quarterly reports. Therefore, it is important to examine the occurrence and the nature of the deviation in understanding more of this issue which then could benefit several parties such as the users, the preparers and the auditors. In addition, it is important to examine the investors' response on the occurrence of the deviation in understanding the need to overcome this phenomenon.

1.1 Roles and Development of Financial Reporting

Financial reporting is an important element in corporate structure which relieves fundamental asymmetry information between the managers who have access to managerial information, and providers of finance who are external to the company (Johnson, Khurana & Reynolds, 2002; Whittington, 1993). This is because shareholders usually have minimal involvement in the management and therefore, have limited information on corporate activities. The recognition of the importance of financial reporting in corporate structure can be seen from the mandatory requirement for a corporation to produce financial accounts by most of the countries.

In general, it can be said that the introduction and enforcement of financial reporting requirements in Malaysia are primarily initiated by regulators. Basically, it is based on the reporting requirements in other developed countries. For example, Companies Act, 1965 is based on the UK Companies Act, 1948 and Australian Uniform Companies Act, 1961 (Craig & Diga, 1996). However, consistent with the unique environment in Malaysia's economics, internally developed reporting requirements have also been introduced such as the *FRS 201 Property Development Activities* and *FRS 204 Accounting for Aquaculture.*

Accounting data clearly furnishes one type of quantitative data that can be used as a basis for making some of the choices that have to be made from among the alternatives available and for checking and evaluating progress and results (Stone, 1967). It also provides a common ground for investors to compare within firms or across time periods (Hodge, 2001). The information provided by financial reporting is useful to a wide range of users (Atrill & McLaney, 2001) and is used in monitoring the management's actions and decisions (Fama, 1980; Fama & Jensen, 1983) and in making investment decisions (Lev & Ohlson, 1982; Penno, 1985).

MFRS 101 Presentation of Financial Statements defines financial statements as a structure representation of the financial position and performance of an entity. The standard highlighted that the objective of these statements is to provide information about the financial position, financial performance and cash flows of an entity which is useful to a wide range of users in economic decision-making process. Financial statements show the results of the management's stewardship of the resources entrusted to it and help users in predicting the entity's future cash flows and in particular, their timing and certainty (M*FRS 101*). Two commonly known financial accounts produced are quarterly accounts and audited annual accounts.

1.1.1 Requirements of Quarterly Reports

Quarterly financial reporting is one type of interim financial reporting, while others can be semi-annually or monthly. The reports are a set of financial statements which are prepared for the period of three months. It can be observed that many countries have mandatorily required their listed companies to produce quarterly reports. Countries such as Malaysia, Pakistan, Singapore, Thailand and the United States are among the countries which require listed companies to produce quarterly accounts. The purpose of the requirement is to enable the market's participants to receive more timely information and thus, allows for more regular monitoring. Timely information helps to reduce uncertainties and enhances confidence over the company's state of affair and thus, improves users' decisions (Ismail & Abdullah, 2009).

Listed companies on the Bursa Malaysia (previously known as Kuala Lumpur Stock Exchange) are mandatorily required in March 1999 to produce quarterly accounts for quarters ending on or after 31st July 1999. This requirement was imposed as a response to the Asian Financial Crisis in 1997/1998 (Ismail & Abdullah, 2009) in replace of the half-yearly reporting which was introduced in 1987 (Ismail & Chandler, 2005a). The contents are much more comprehensive than the half-yearly reporting (Ismail & Chandler, 2005a). Currently, the requirement is regulated under Chapter 9.22 of the Main Market Listing Requirements of Bursa Malaysia, where listed companies are mandated to produce their quarterly accounts not later than two months after the end of each quarter. Part A of Appendix 9B of the Main Market

Listing Requirements of Bursa Malaysia further elaborates the information that needs to be disclosed in the accounts.

In response to the Bursa Malaysia's requirement, the MASB issued the *DSOP 4 Interim Financial Reporting* in 1999 and after going through the due process of standard setting, in which no major changes has been made, the Statement became a standard in 2002, named as *MASB 26 Interim Financial Reporting* (Ismail & Chandler, 2009). The standard is an adoption of *IAS 34 Interim Financial Reporting* issued by the IASC in 1998 and currently, the standard is known as *MFRS 134 Interim Financial Reporting.*

In general, this standard requires companies to prepare the quarterly reports as audited annual financial statements where accounting policies and method of computation are required to be consistent with those adopted in the audited financial accounts. Therefore, the new and revised Financial Reporting Standards which became effective for the financial period need to be adopted. Furthermore, while initially the mandatory contents set up by Listing Requirement only include a balance sheet, an income statement and specific notes accompanying the accounts, *MASB 26* requires a company to include a cash flow statement and a statement of changes in equity (Ismail & Chandler, 2009).

Prior to the introduction of *MASB 26,* companies had the choice of adopting either the integral or discrete method in preparing the quarterly accounts (Ismail & Abdullah, 2009). However, the issuance of *MASB 26* in 2002 and was made effective on 1st July 2002 required companies to use the discrete method than integral method as the main view in dealing with most of the transactions (Ismail & Chandler, 2009). The integral method views quarterly accounts as integral parts of the annual period and thus, accruals, deferrals and estimations at the end of each quarter are affected by judgments regarding operations for the entire year (McEwen & Schwartz, 1992). Meanwhile, under the discrete method, the reported accounts should only reflect the economic activity of that particular quarter, independent from the other quarters (Ismail & Abdullah, 2009; Mendenhall & Nichols, 1988). Thus, suggesting that the cost that benefits more than one interim period is not to be anticipated or deferred and therefore, the expense is fully recognized in the period in which it incurred (Ismail & Abdullah, 2009; Mendenhall & Nichols, 1988). The application of the discrete method rather than integral method is believed to be able to provide more reliable quarterly accounts (Ismail & Abdullah, 2009).

Even though both methods differ in the treatment of expense, the basic idea of the preparation of quarterly account is that, the cumulative quarterly accounts' numbers (the summation of all quarterly accounts numbers) would be similar to the audited annual accounts (Ibrahim et al., 2009; Ismail & Abdullah, 2009). This is due to the fact that the accounting policies and estimation methods applied in quarterly accounts are required to be consistent with those adopted by the annual accounts. Therefore, quality quarterly accounts (cumulatively) should report the same accounting numbers as audited annual accounts.

1.1.2 Requirements of Audited Annual Reports

The production of audited annual accounts is mandatory to a corporation in most of the countries. In Malaysia, the requirement is regulated under the Companies Act, 1965. The legislation regarding the preparation and the contents of these accounts are set out in Sections 166A to 171 and elaborated further in the Ninth Schedule of the Act. Meanwhile, Sections 172 to 175 of the Companies Act, 1965 rule the appointment, remuneration, privileged, duties and responsibilities of the auditors.

In addition, the financial statements are also required to comply with the accounting standards issued by the MASB. The MASB which is formed in 1997 has been discharged by the government to formulate accounting standards in Malaysia. Previously, most standards have been modified from standards published by the IASB and a few are internally developed (such as *FRS 201 Property Development Activities* and *FRS 204 Accounting for Aquaculture*). However, beginning 1st January 2012, MASB has required full convergence with the *IFRS* and these standards are named as the *MFRS.*

The requirement for the financial accounts to be audited by an external auditor is to enhance the credibility of financial information contained in the reports. While the financial reporting is prepared by the management, adding the audit function can enhance the credibility of the report whereby the users have reasonable assurance that the financial statements do not contain material misstatements or omissions (Messier & Boh, 2002). In general, an auditor is required to examine the correspondence between information provided in the financial accounts and their standards and give the reports on the correspondence. In discharging these responsibilities, auditors need to accumulate and evaluate the evidence and at the final stage issue an audit opinion. The auditor's report attests to the truth and fairness of such statements and in doing so provides a degree of assurance to users of the financial statements that the statements are free of material misstatements (Ismail & Iskandar, 2003). In fact, Antle and Nalebuff (1991) argued that financial reports are a joint statement by auditor and management. The intuition is based on the fact that an auditor may request for adjustments in the financial reports if they are not satisfied with the accounts prepared by the management. If the adjustments have not been properly made, auditors can highlight the incompliance in their reports. Therefore, it can be assumed that audited annual accounts are at a high level of quality which are free from any errors and manipulations.

1.1.3 Quarterly Reports Quality - A Research Agenda

The quality of financial reporting has been a subject of a wide range of studies. This is because accounting itself involves alternative methods of application (such as accounting for inventory) and estimations (such as for depreciation, receivables) which can be manipulated by the management in presenting their desired numbers. At the same time, low quality financial reporting may be due to the problem in the financial reporting process. Human errors and software failures are among the possible problems that may exist in the process of preparing the financial reports. To ensure the quality of financial reporting, internal and external mechanisms (mandatorily or voluntarily) have been adopted by corporations. Formation of audit committee, establishment of internal audit and external auditing are among the mechanisms used. However, despite the move, low quality financial reporting still existed (see for example Beasley, 1996; Kinney Jr. & McDaniel, 1993; McMullen, 1996).

Most of the earlier studies of financial reporting quality focus on the audited annual accounts. Only limited studies have been done on the quality of quarterly accounts. The exceptions are by Ismail and Abdullah (2009), Ismail and Chandler (2005a) and Kinney and Trezevant (1997) who had focused on deferment of exceptional items; Ismail and Rahman (2011), Kinney Jr. and McDaniel (1989) and McMullen (1996) who had focused on restatements of quarterly earnings; Das, Shroff and Zhang (2009) who had focused on fourth quarter reversal; Ismail and Chandler (2004a) who had focused on reporting lag and Ismail and Chandler (2005b), McEwen and Schwartz (1992) and Rahman and Ismail (2008) who had focused on disclosure quality.

While quarterly accounts are shown to be as important as the audited annual accounts in monitoring and economic decision-making process (see for example Ismail & Rahman, 2012; Kross & Schroeder, 1984; Lee & Park, 2000) hence, the need for quality quarterly accounts is also as important as the need for quality audited annual accounts. Furthermore, fraudulent audited annual accounts often begin with misstatements in the quarterly accounts (Yang & Krishnan, 2005) and thus, by enhancing quality quarterly accounts can ensure the quality of audited annual accounts.

1.2 Problem Statements

There has been consistent calls for better quality and accurate financial reporting due to the importance of these reports in the economic decision making process. Lack of quality may mislead users' judgments. At the same time, the limited access to managerial information causes the financial providers and other related parties to rely heavily on the financial reports. However, the heavy reliance placed on accounting numbers creates a strong incentive for managers to manipulate financial reporting to their own advantage such as to increase their compensation or even worst, to cover-up their wrong doings (Rahman & Ali, 2006). As noted earlier, companies are required to produce quarterly accounts so that users will have more timely information rather than having to wait for the annual accounts. Despite this benefit, many are skeptical about the quality (more specifically on the reliability) of information contained in the accounts (see for example Ibrahim et al., 2009; Ismail & Abdullah, 2009; Lightstone et al., 2012). As noted by Lightstone et al. (2012, p. 298)

> “While interim reports increase the relevance of the financial statements through more timely communication of position and results, their usefulness to users is also a function of their reliability”.

The quality of quarterly accounts has become an issue since auditors’ involvement is not required in most jurisdictions. Hence, the accounts are exposed to the risk of errors and manipulations by the managers (Ismail & Chandler, 2005a). Evidence indicates that there are many instances where information provided in quarterly accounts may not be accurate. For example, Lightstone et al. (2012) reported that volatility of net income in each of the first three quarters is lower than in the fourth quarter which suggests for possible earnings management in the earlier quarter. Meanwhile, in Malaysia, Ismail and Abdullah (2009) and Ismail and Chandler (2005a) have both found the tendency of companies to defer the exceptional items to the fourth quarter reporting. Furthermore, Ismail and Rahman (2011) had found that almost 20 percent of listed companies in year 2005 amended their quarterly accounts. As a result, the issue of the quality of quarterly accounts has been raised. Hence, recent concerns by regulators on financial reporting quality have been focusing on these quarterly accounts. While quarterly accounts are prepared for a three month period, conceptually the cumulative quarterly accounts' numbers (the summation of all quarterly accounts) can be assumed to be the same as the audited annual accounts. This is because the accounting policies and estimation methods applied in quarterly accounts are required to be consistent with those adopted by the annual accounts. Therefore, Al-Darayseh and Brown, Jr. (1992) and Ibrahim et al. (2009) have hypothesized that the occurrence of deviation between the two accounts as an evidence of lack of quality in quarterly accounts. Both studies assumed that the deviation is a result of misstatements in the quarterly accounts. Users who rely on these quarterly accounts in their judgment may make erroneous economic decisions and in return may incur losses in their investments. The concern by the Bursa Malaysia on the occurrence of earnings deviation has led to the mandatory disclosure announcement, whereby companies with 10 percent and more deviation between earnings in cumulative quarterly accounts and audited annual accounts are required to make immediate announcements concerning the deviation with complete explanations [Chapter 9.19(35) Main Market Listing Requirements of Bursa Malaysia].

Ibrahim et al. (2009) can be considered the first study to examine the occurrence of earnings deviation between cumulative quarterly accounts and audited annual accounts in Malaysia. By using a sample of 261 listed companies from both Main and Second Board of Bursa Malaysia in 2004, the study reported that 64 percent of the sample companies has deviation between their earnings reported in cumulative quarterly accounts and in audited annual accounts. It is also reported that a slight majority (52 percent) of companies with earnings deviation have more favorable earnings (higher profit or lower loss) in the cumulative quarterly accounts than in audited annual accounts, which implies that these companies tend to overstate their quarterly accounts. In addition, the study had also found that 70 percent of the deviation companies has more than 1 percent deviation, in which 20 percent with more than 10 percent deviation. Furthermore, the Logistic regression shows that an effective audit committee could limit the occurrence of this deviation. Despite these contributions, several important issues have not been examined in the study and thus, are explored in this study.

The evidence on the occurrence of the deviation as presented by Ibrahim et al. (2009) is only based on a sample of 261 listed companies in Bursa Malaysia in 2004. While the production of quarterly accounts is mandatorily required since 1999, there is a possibility of difference in occurrence and magnitude of deviation across time period. Furthermore, the study only provided descriptive information on the occurrence of earnings deviation without testing the materiality of the deviation in influencing users' decision-making. As a consequence, limited conclusions have been made on the occurrence of earnings deviation in the study. Even though theoretically, the occurrence of earnings deviation represents low quality of quarterly accounts, further examination on the occurrences, signs and magnitude of deviation is important in assessing the reliability of quarterly accounts. In addition, the study had only assumed that the occurrence of earnings deviation is due to misstatements in the quarterly accounts, however, earnings deviation may also be caused by the compulsory adjustments due to the occurrence of events after the announcement of the fourth quarterly accounts (usually termed as events after reporting period). A company may need to make some adjustments to reflect the occurrence of the events and these adjustments may therefore, result in the difference in the cumulative quarterly earnings and the audited annual earnings. Furthermore, as conceptualised by scholars of earnings manipulation (see for example Dechow et al., 1996; DeFond & Jiambalvo, 1991), misstatements can be in two forms; errors and manipulations. While errors are considered as unintentional misstatement which is due to the problems in the financial reporting process, manipulation on the other hand is intentional misstatements by the management to report their desired numbers (Dechow et al., 1996). All these important issues have not been distinguished in the study by Ibrahim et al. (2009).

In addition to this, two accounting methods have been recommended in the preparation of quarterly accounts. The IASB prefers the discrete method, whilst the FASB prefers the integral method. While the preference of FASB can be related to the objectives for a more accurate estimation of future results, some believed that the discrete method will be able to provide more reliable quarterly accounts (see for example Ismail & Abdullah, 2009; Mendenhall & Nichols, 1988). However, the belief is only based on the intuition where empirical evidence is weak. For example, a study by Ismail and Abdullah (2009) found insignificant difference in the percentage of companies which delay the reporting of exceptional items to the fourth quarter after the mandatory use of discrete method in Malaysia. At the same time, while theoretically the occurrence of earnings' deviation can be viewed as low quality quarterly accounts, the users' perspective on the deviation is still unclear. Users may have different views than the theoretical assumptions. As the main users of quarterly accounts, investors' perspective towards the occurrences of the deviation is important to be examined in order to provide a clearer picture on this phenomenon.

1.3 Research Questions

Based on the above discussion, the following research questions are raised:

1. Are audited annual earnings produced by listed companies on Bursa Malaysia different from their cumulative quarterly earnings?
2. Do companies with overstated quarterly earnings have higher magnitude of deviation than companies with understated earnings?
3. Does the use of discrete method rather than integral method in preparing quarterly accounts limits the occurrences and magnitude of earnings deviation?
4. Are the signs and magnitude of earnings deviation related to earnings' performance of the corporation?
5. Is earnings deviation more related to misstatements in quarterly accounts rather than adjustments of events after the reporting period?
6. Do investors of Bursa Malaysia presumed lower reliability on the quarterly earnings produced by companies experiencing earnings deviation?

1.4 Research Objectives

The main objective of this study is to assess the reliability of quarterly accounts by examining the occurrence and the nature of earnings deviation between audited annual accounts and cumulative quarterly financial accounts (termed as earnings deviation) among listed companies in Malaysia. In addition, this study also provides evidence of the users' perspective on the occurrence of the deviation. More specifically, the objectives of this study are:

1. to examine whether the annual earnings reported in audited accounts significantly differs from cumulative earnings reported in quarterly accounts;
2. to examine whether the magnitude of deviation of overstated quarterly earnings companies is significantly higher than understated companies;
3. to investigate whether the use of discrete method rather than integral method in preparing the quarterly accounts limits the occurrences and the magnitude of earnings deviation;
4. to examine whether the signs and magnitude of earnings deviation are related to earnings' performance of the corporation;
5. to examine whether the earnings deviation related to misstatements are significantly higher than earnings deviation related to adjustments of events after the reporting period;
6. to examine whether the earnings response coefficient of quarterly earnings of non-deviation companies is significantly higher than deviation companies.

1.5 Significance of the Study

This study is consistent with the continuous concern on the quality of financial reporting among users and by regulators. As highlighted by Yang and Krishnan (2005), a fraudulent financial reporting often begins with misstatements in the quarterly accounts. By enhancing the quality of quarterly reporting, it can uphold the quality of annual reporting. Therefore, this study contributes to the policy, theoretical and methodological implications.

Findings from this study could be beneficial to help users of quarterly accounts in understanding the occurrences and the nature of earnings deviation and thus, the reliability of quarterly accounts. It is also beneficial to company's management, board of directors and audit committee in improving the quality of quarterly accounts. Last but not least, this study could also shed some light to the regulatory bodies on the importance to cater the phenomenon of the occurrence of earnings deviation. While quarterly reporting helps in disseminating a more timely and relevant information (Lightstone et al., 2012), the occurrence of earnings deviation may outweigh this benefit. Currently, the Bursa Malaysia has only required for companies with 10 percent or more to provide immediate announcement and explanation on the deviation.

In general, this study adds to the growing literature on the quality of interim financial reporting, particularly quarterly reporting and on earnings response coefficients. Earlier studies have separately provided evidence on the occurrence of earnings deviation between cumulative quarterly earnings and audited annual earnings (see for example Al-Darayseh and Brown, Jr., 1992; Ibrahim et al., 2009) and the use of quarterly accounts by investors in their economic-decision making (see for example Ismail and Rahman, 2012; Kross & Schroeder, 1984; Lee & Park, 2000). This study on the other hand, provides empirical evidence on the effect of earnings deviation on investors' reliance to the quarterly accounts. In addition, both the earlier studies by Al-Darayseh and Brown, Jr. (1992) and Ibrahim et al. (2009) had only examined the occurrence of earnings deviation and assumed that it represents misstatements in quarterly accounts. This study presents a more comprehensive study by not only examining the occurrence but also exploring the nature of deviation, which then can bring insight knowledge on the deviation. Meanwhile, the study by Ibrahim et al. (2009), a Malaysian study, is only based on a sample of 261 listed companies of Bursa Malaysia in 2004. By using the sample of listed companies on Bursa Malaysia from the year 2000 (which is the first year for a completely available all four quarterly reports) up to 2012, this study provides a comprehensive information about the phenomenon. Furthermore, as compared to survey approach which only examines investors' perceptions, the market approach applied in this study investigates both investors' perceptions and actions. Moreover, while earlier studies had examined the effect of auditors' association on investors' reliance to the quarterly earnings (see for example Lee et al., 2014; Malek, et al., 2016), this study on the other hand, focuses on the occurrence of earnings deviation. In addition, different types of earnings deviation are also explored which can bring more in-depth understanding on the phenomenon.

Meanwhile, the belief that the use of discrete method can enhance the quality of interim reporting is only based on intuition where empirical evidence is limited. In an earlier Malaysian study by Ismail and Abdullah (2009) had found that the use of discrete method does not affect the quality of interim reporting. The study found insignificant difference in the percentage of companies which reported exceptional items in the fourth quarter before and after the mandatory use of discrete method. While the study is constrained from timing issues of reporting the exceptional items, this study uses a more direct measure of quality quarterly earnings, besides adding to the limited empirical evidence on the effect of accounting method.

Last but not least, this study also provides evidence of the managers' behavior in preparing the financial reports, particularly quarterly financial reporting. It also provides evidence on auditors' behavior in discharging their responsibilities and investors' behavior on the occurrence of earnings deviation.

1.6 Summary and Organization of Remaining Chapters

This chapter begins with a general discussion of quarterly financial reporting quality which highlights the issue of the occurrence of deviation between audited annual accounts and cumulative quarterly accounts. The next section discusses the background of financial reporting in the Malaysian business environment followed by discussion on problem statements, research question and research objectives. In summary, as in other countries, the production of audited annual accounts is mandatory for a corporation in Malaysia whilst the production of quarterly accounts is only mandatory for listed companies on Bursa Malaysia. Even though quarterly accounts are important in disseminating timely information, skepticism on the quality of these accounts existed as external auditing is not required. The occurrence of earnings deviation between cumulative quarterly accounts and audited annual accounts raise the questions on the quality of quarterly accounts. Therefore, the objective of this study is to assess the reliability of quarterly accounts by focusing on the deviation between audited annual earnings and cumulative quarterly earnings.

The next chapter reviews the relevant literature on financial reporting focusing on financial reporting quality and quarterly accounts. Chapter 3 develops the hypotheses to be tested and is followed by a discussion of sample data, research design and variable measurement in Chapter 4. Chapter 5 discusses the results of analyses and Chapter 6 discusses the findings, limitation, implication and the conclusion of this study.

CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

Chapter 1 begins with a discussion on the background of financial reporting focusing mainly on the quarterly accounts. It then discusses the problem statements related to quarterly accounts quality, followed by research questions and research objectives of this study.

This chapter reviews the relevant studies on quarterly financial reporting which focuses mainly on its quality. It begins with a discussion on the conceptual objectives of financial reporting followed by a review of the historical background of quarterly financial reporting and a discussion on the requirement by the IASB. The chapter continues with a review of the objectives of quarterly accounts and a review of relevant studies done on the use of quarterly financial reporting in the capital market. The subsequent sections discuss the qualitative characteristics and issues related to quarterly accounts, provide a review of literatures on perceptions towards quarterly reports and discuss regulators' move to enhance quarterly reporting quality. It is then followed by a review of prior studies on the quality of quarterly financial reporting. The final section summarizes this chapter.

2.1 Conceptual Objectives of Financial Reporting

Financial reporting is one of an important element in the corporate governance structure by relieving asymmetry information between managers and other parties (Whittington, 1993). Even though, information can also be obtained from other sources, financial reports provide the most comprehensive and reliable information.

In general, financial reporting is a form of structured financial information on an entity's performance and position. The reports consist of a statement of financial position as at the end of the period, a statement of comprehensive income for the period, a statement of changes in equity for a period, a statement of cash flows for a period and notes of summary of significant accounting policies and other explanatory information (*IAS 1 Presentation of Financial Statements*). In addition to that, a statement of financial position as at the beginning of the earliest comparative period is also required to be prepared if the retrospective application, restatement and reclassification of items is used (*IAS 1 Presentation of Financial Statements*).

The information provided by financial accounts represents the outcome of management's actions and decisions during a period of time. It provides an indication on how management managed and utilised the company's resources (Jaffar et al., 2007). Good company's performance and position represent that the managers have successfully managed the company's resources whilst poor performance and position represent managers' failure.

The literature on the need of financial reporting are usually discussed within two perspectives. One view is that financial reporting is important in monitoring and another view is that financial reporting is important in investment decisions. Whilst the first concentrates on the objective of financial reporting in the business structure, the second concentrates on the capital market. Even though, both structures are different, in general, the financial reporting can be viewed as an important source in decision-making process. The concepts of financial accounts, which report the financial performance for a period of time and financial position at the end of period,