Researchers examine financial reporting consequences of rigid accounting regulation

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Strict mandates on financial reporting sometimes lead to mismatch between a company's business cycle and its fiscal year on paper. Recently, researchers have examined the reliability of financial reports

under the mismatched condition compared to that when the seasonal business activity is aligned with the government-mandated fiscal year. They found that reports produced in the mismatch condition had more abnormal accruals. However, the low reporting quality was attributable to unintentional, and not deliberate, estimation errors.

The accounting period plays a significant role in the function of financial reporting—the process of documenting and communicating financial activities and performance—and is also crucial for achieving financial accounting objectives, which are an important premise of accounting work. Setting the ideal start and end dates of the accounting year has always been one of the most controversial problems in accounting measurement.

Mandates around the time of financial reporting have been a subject of intense global debate. The proponents of uniform financial reporting contend that the financial statements of all companies nationwide are more comparable under uniform financial reporting, benefitting regulatory agencies and investors.

People in the opposite camp argue that since flexibility in financial reporting helps companies align their fiscal year with seasonal changes in business activity, managers are less burdened with creating financial statements, resulting in more reliable reports. As a result, while some governments have strict regulations around financial reporting, others are more flexible.

China, India, Mexico, Russia, Saudi Arabia, South Korea, and Turkey—all among the top 20 economies—require businesses under their jurisdiction to submit yearly financial statements at the same time of the year nationwide. Owing to a uniform stipulated financial period, all companies in these countries start and end their fiscal year simultaneously, regardless of seasonal variations in business activity. In

contrast, other countries, especially in the West, are more flexible regarding the period of financial reporting.

But what consequences does this have for business? In a study published in *The Accounting Review* a group of researchers in China speculated that the mismatch between fiscal year and seasonal variations in business activity, attributable to mandated uniform financial reporting, impacts the reliability of financial statements of businesses.

The study, led by Dr. Kangtao Ye of Renmin University of China, included contributions from Dr. Zhe Li of the Central University of Finance and Economics, Dr. Cheng Zeng of The Hong Kong Polytechnic University, and Dr. Bo Zhang of Renmin University of China.

"Using extensive interviews together with large-sample archival analyses, our study examines the financial reporting consequences of a rigid accounting rule in China, under which the fiscal year-end is uniform for all companies," explains Dr. Ye.

The researchers found that financial reports produced under the mismatched condition had higher levels of abnormal accruals—accounting errors where accruals do not reflect normal business activity—compared to the reports in the scenario where seasonal business activity was aligned with the government-mandated fiscal year.

What does this translate to in business terms? Dr. Li explains, "We found that mismatched firms have lower analyst forecast accuracy, higher forecast dispersion, longer audit reporting delays, and higher audit fees relative to non-mismatched firms." Clearly, the impact of such mismatch on business is substantial.

Interestingly, the researchers observed that the mismatch was not

intentional, however. Dr. Zeng surmises, "The companies with mismatches between business cycles and uniform fiscal years had higher abnormal accruals. However, further analyses showed that the negative correlation between the aforementioned mismatch and the quality of financial reporting was mainly due to unintentional mistakes rather than deliberate earnings manipulation."

This is good news as it indicates the problem is process-related, which may be solved through the correct legislation. The business world has recently seen a global convergence in accounting standards and practices. Therefore, efforts are underway to have a standard system for financial reporting worldwide. The findings of this study may provide theoretical backing for such a potential global system for financial reporting, which could address this issue of mismatch and its consequences.

"In the current revision process of China's accounting law, changes may be made at any time. The present research results are in line with official recommendations, and they will likely attract the full attention of the legislature," points out Dr. Zhang. The researchers are hopeful that in the future accounting rules will be based more on empirical evidence, such as that obtained in their study, so that disputes could be alleviated effectively.

More information: Zhe Li et al, Ending at the Wrong Time: The Financial Reporting Consequences of a Uniform Fiscal Year-End, *The Accounting Review* (2022). DOI: 10.2308/TAR-2018-0461

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