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Should the SEC ditch quarterly reporting?

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In the minds of some, the manifold ills of corporate capitalism have a

single source: short-termism. Because investors increasingly ignore long-term value in favor of quarterly returns, corporate managers are thought to have no choice but to adopt a similarly myopic mentality in their decision-making.

In recent years, widespread concerns about short-termism have helped to rejuvenate the debate around the Securities and Exchange Commission (SEC)'s quarterly-reporting rules. For example, in 2018 the Trump administration instructed the SEC to investigate returning to a semiannual (i.e. twice yearly) requirement, which was in force from 1955-1970.

In a forthcoming paper for *Accounting Horizons*, David S. Koo, an assistant professor of accounting at the Donald G. Costello College of Business at George Mason University, revisits this history to determine whether switching back to semiannual reporting would automatically curtail short-termism.

His study compares corporations that voluntarily switched to more frequent reporting before it was required, to those that switched only when obligated to do so. The data-set tracked financial performance and earnings data for 201 matched pairs of companies, during the years 1952-1974. (Koo's co-authors were Jenna D'Adduzio of the University of British Columbia, Santhosh Ramalingegowda of University of Georgia, and Yong Yu of the University of Texas at Austin.)

As a proxy for investors' short- vs. long-term thinking, the researchers used the future earnings response coefficient (FERC). As Koo summarizes, "FERC measures the extent to which the current stock price reflects the future earnings of the company." High FERC suggests a long-term orientation where investors correctly anticipate companies' future

earnings over time, and price them accordingly.

The research team found that switching from annual to semiannual, and from semiannual to quarterly reporting had a consistent elevating effect on a corporation's FERC. In other words, more frequent snapshots of corporate performance appeared to give investors fundamental insights into a corporation's state of health, rather than incentivizing knee-jerk responses based on ephemeral data.

"Suppose we have annual reporting, and the corporation earns $100 million one year and $95 million the next," Koo explains. "All we know is that the company's earnings decreased by $5 million. But if we can compare quarter to quarter, we can hypothesize whether the reduced performance is idiosyncratic, or there's something really going on with the company."

More frequent financial reporting, therefore, provides more context and perspective to work with when interpreting earnings information.

Further, the increase in FERC was found to be greater for companies with less predictable or uneven earnings patterns. Examples would be those in industries like commercial aviation and retail, with a high degree of seasonality. Quarterly reporting allows investors and analysts to isolate business-critical periods of time—such as the holiday shopping season or the summer travel rush—and assess performance relative to previous years as well as competitors.

The study suggests that the move to quarterly reporting also curbs short-termism by increasing the frequency of other types of disclosures, thus creating more informational opportunities for investors. Koo and his co-authors found that the average number of management earnings forecasts shot up after companies were forced to switch to quarterly reporting.

Koo argues that this domino effect of disclosure shows that "in capital markets, financial reporting is a centerpiece…If we make reporting less frequent, maybe the repercussions could be bigger. Analysts and companies may disclose less than before."

At the same time, Koo emphasizes that increasing the cadence of financial reporting even further—to, say, a monthly schedule—might be too much of a good thing. "Too-frequent reporting can be very costly for the company and overwhelm investors with too much information," he says.

Instead, he urges policymakers to remember the original rationale for the quarterly-reporting requirement. "After World War II, the U.S. economy was booming, then there was a recession. Many companies that thrived during post-war expansion were able to hide their shrinking performance, which cost investors a lot of loss. The purpose of quarterly reporting was to reduce that information asymmetry." Koo's findings suggest that the SEC was right back in 1970: Quarterly financial reporting may be the sweet spot for capital markets.

A working paper version of the research is available in the *SSRN Electronic Journal*.

More information: Jenna D'Adduzio et al, Does More Frequent Financial Reporting Bring the Future Forward?, *SSRN Electronic Journal* (2023). DOI: 10.2139/ssrn.4425928

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