Challenges of the new quarterly reporting regime

SGX needs to be watchful of companies doing "auditor shopping" to get an unmodified opinion. **BY MAK YUEN TEEN AND CHEW YI HONG**

ON JAN 9, 2020, Singapore Exchange Regulation (SGX RegCo) announced that it will only require companies associated with higher risks to report quarterly results. It sees this risk-based approach as being more targeted and less arbitrary than the size-based approach that has been in operation since 2003.

Meanwhile, the continuous disclosure regime is being strengthened, with proposals such as stricter rules on interested person transactions, and improving valuations and external audits. SGX RegCo has also established a whistleblowing office and plans to "hard-code" into the listing rules the requirement for companies to have a proper whistleblowing policy.

A risk-based approach is also used in markets such as Hong Kong and Australia. In Hong Kong, quarterly reporting (QR) applies to companies listed on GEM, which was historically aimed at growth companies, but is now considered a board for small and mid-cap companies.

Australia requires mining, oil and gas exploration companies, cash commitment companies and companies making a significant change to the nature or scale of their activities to produce quarterly cash flow reports.

For Hong Kong and Australia, companies that are required to report quarterly are expected to have higher risk but may not necessarily do, as companies are not screened using specific risk factors. We can consider them as "ex ante" approaches.

SGX RegCo now imposes QR on companies that are already known to have high risk, based on historical information – an "ex post" approach. BT FILE PHOTO

A DIFFERENT RISK-BASED APPROACH

In contrast, SGX RegCo now imposes QR on companies that are already known to have high risk, based on historical information – an "ex post" approach. Under the new approach, a company will have to report its financials on a quarterly basis if:

- It has received a disclaimer of opinion, adverse opinion or qualified opinion from its auditors on its latest financial statements;
- Its auditors have expressed a material uncertainty relating to going concern on its latest financial statements; or
- SGX RegCo has regulatory concerns with the company, for example if it has had material disclosure breaches or where it faces issues that have material financial impact.

QR will not apply when companies are undergoing judicial management, provisional liquidation or winding up, as well as to "cash companies". Based on these criteria, 109 companies are required to do QR, with companies that are not currently doing it given a one-year grace period. The new QR regime here is also more targeted than those in Australia and Hong Kong.

DIFFERENT OBJECTIVES

The previous size-based approach and the new risk-based approach also achieve rather different objectives.

QR was introduced in Singapore in 2003 because it was felt that more timely information is useful for investors in making investment decisions. To quote the final report of the Disclosure and Accounting Standards Committee which recommended QR: "The Internet revolution has brought about dramatic changes to the business world. Adequate and timely information is needed for management to make effective decisions to compete in this dynamic environment. On this basis, investors also require timely information to make investment decisions. The current rules of the SGX require listed companies to announce interim results on a half-yearly basis. The committee considers this frequency to be insufficient in the current environment."

Smaller companies were then exempted by the government because it was felt that it would be too costly, not because it was not beneficial.

However, the quarterly reports for the 109 companies now required to do QR are unlikely to be useful for investment decisions because they are imposed on companies with already well-documented problems. For most of these companies, significant shareholder value has already been destroyed. They are likely to be avoided by most investors, except perhaps speculative investors. In fact, 15 of these companies are on the list of long-suspended companies as at Nov 29, 2019.

Requiring these companies to do QR is useful for a different reason – accountability. Companies which are poor in compliance are made to account to their shareholders more frequently. It may also encourage companies with modified audit opinions to get their act together.

IS ONE YEAR OF UNMODIFIED AUDIT OPINION ENOUGH?

Based on SGX RegCo's criteria, we do not have any issue with the 109 companies that are now required to do QR. However, we do wonder if the criteria are sufficiently robust.

Perhaps SGX RegCo should extend its criteria to two or possibly three years of clean audit opinion.

Take the case of one company that is audited by a Singapore mid-tier audit firm that has been barred from undertaking audits of public companies by the Securities Commission's Audit Oversight Board in Malaysia.

This company had to re-issue financial statements for the preceding two years, one of which is qualified and the other has two "emphasis of matter" (EOM) issues and five key audit matters (KAMs).

Both were re-issued close to the release of its latest audited financial statements, which received an unmodified opinion. The company also has a number of other issues. Under SGX RegCo's criteria, it is not required to do QR on account of the unmodified opinion for its latest financial statements.

Or consider the case of YuuZoo Corporation (now YuuZoo Networks Group Corporation). It had three different external auditors after listing, and its first four sets of post-listing financial statements respectively received the following four audit opinions: an unmodified opinion from BDO LLP who then declined re-appointment; a disclaimer of opinion from Moore Stephens LLC who also declined re-appointment; an unmodified opinion (with two EOMs and seven KAMs) from RT LLP; and then a disclaimer of opinion from RT LLP who were not re-appointed at the AGM. Let's hypothetically assume that the current QR regime was introduced when YuuZoo received the third (unmodified) opinion from RT. Does it mean that it would not have to do QR?

Or what about MMP Resources which received six successive disclaimers of opinion from three different external auditors? Hypothetically, if it were to receive an unmodified opinion for its latest financial statements, would it be exempted from QR?

> If companies have received a qualified or disclaimer of opinion due to lack of proper records or supporting evidence, or frequently re-state their results, can their quarterly reports be relied upon?

To be clear, YuuZoo and MMP Resources are among the 109 companies. However, based on SGX RegCo's criteria, it would appear that they could have been exempted if they had received an unmodified opinion for their latest financial statements.

SGX also needs to be watchful of companies doing "auditor shopping" to get an unmodified opinion. We could also imagine the pressure external auditors may now face under the new QR regime if they are to issue an unmodified opinion.

One company has received successive unmodified audit opinions, but the directors have recently warned of going concern issues. It has a recent history of problems which has led to considerable financial losses and seen shareholder value decimated.

However, it is not considered "bad enough" to be included in the list.

Companies that are on SGX's watchlists are also not required to do QR (unless they are also caught by the QR criteria). In the consultation, it was explained that these companies have to provide quarterly updates on their efforts and progress in meeting the exit criteria. However, we view such updates as standard boilerplates which do not provide the same information as quarterly reports.

We believe that those on the financial criteria watchlist should be required to do QR as they have already made three successive years of losses, and many struggle to exit and face delisting. Exactly half the companies – or 22 companies – that are still listed and currently on the financial criteria watchlist are not required to do QR. Not surprisingly, none has volunteered to do so.

Then there are companies that make material or frequent re-statements to their results or regularly have large variances between audited and unaudited results. An example is an S-chip that announced material variances in each of its last three financial years. These are all signs of poor internal controls and high financial reporting risks. However, it did not make the list.

This brings us to one potential problem with the new approach. If companies have received a qualified or disclaimer of opinion due to lack of proper records or supporting evidence, or frequently re-state their results, can their quarterly reports be relied upon? YuuZoo restated its previous quarterly results each time it released its latest quarterly results.

Any QR regime is only meaningful if directors are held accountable for inaccurate quarterly reports.

Finally, while we believe in the professionalism of SGX RegCo in setting the hurdle for companies that have to do QR, it may also be concerned that putting too many companies on the list will send the "wrong" message about the quality of companies on SGX.

INVESTORS' VIEWS ARE CLEARLY DIFFERENT

Based on a survey that was carried out by the two authors in May 2017 and summarised in an article titled *Scrapping quarterly reporting a bad move* (BT, Aug 16, 2017), 58 per cent of the respondents said that quarterly results were critical in their investment decisions, and 30 per cent said that they used quarterly results with other sources of information. Some 12 per cent said that they did not use quarterly results for their investment decisions but still looked at them, and none said that they did not look at quarterly results at all. This was based on the views of 69 retail investors and seven institutional investors.

According to a recent snap poll of 40 active analysts, institutional investors and those in institutional sales conducted by investor relations firm Financial PR, 75 per cent prefer QR, and 78 per cent believe that removing QR will have a negative impact on liquidity, especially for small and mid-cap stocks. Eighty-two per cent said they prefer to meet management at least quarterly despite half-yearly reporting, while 95 per cent said they would settle for partial disclosure on a quarterly basis if QR was discontinued.

Partial disclosure is what DBS Group said it would do after it announced that it would discontinue QR. Not surprisingly, since the new regime came into effect on Feb 7, many companies have announced that they will discontinue. Given the short notice, some still proceeded to release their latest quarterly results during the first two weeks of February but this is not indication that they will continue to do so.

COMPANIES BUCKING THE TREND

So far, we have found only five companies that have said they will voluntarily continue QR and they are: Del Monte, Fortress Minerals, iFast, Micro-Mechanics and UMS.

The first author spoke to the executive director and chief financial officer of Micro-Mechanics (MM), Chow Kam Wing, about the company's decision to continue with QR. MM has a long history of being transparent and practising good corporate governance.

He said the board was unanimously convinced of the benefits of continuing with QR and it was not a difficult decision to make. One of those benefits was improved liquidity. He had observed that there was more trading of the company's shares around its quarterly results announcements and felt that they conveyed useful information about trends. He did not see QR as creating short-termism as the company thinks about long term sustainable growth and profitability.

Mr Chow felt that their investors need the information and that smaller companies with less analyst coverage will benefit from QR. The board also benefits from getting the full quarterly reports as these provide information beyond monthly management accounts. The board meetings to discuss the quarterly results prior to announcement are also useful.

We have heard some independent directors express concerns that ceasing QR will result in them receiving less information to discharge their duties, as companies may feel that there was no need to provide the full QR information anymore. There may also be less board and management interactions.

On the question of cost, Mr Chow said it was mainly management (especially his) time and the CEO having to fly in from the US (where he is based) for the board meetings to discuss the quarterly results. However, he and the company were convinced that the benefits far outweigh these costs.

Perhaps this is why MM, which has active interest in its stock, has seen its market capitalisation increase from around S$100 million to more than S$230 million today, and paying out over S$47 million in dividends in just over four years. Its current share price is nine times its IPO price in 2003. Meanwhile, the QR quitters may find their fortunes heading the other way.

Mak Yuen Teen is an associate professor of accounting at the NUS Business School, where he specialises in corporate governance. Chew Yi Hong is an active researcher and investor.

Source: The Business Times © Singapore Press Holdings Ltd. Permission required for reproduction.