Japan's pending reform of quarterly financial reporting is more involved than it may seem

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Executive Summary

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In June 2022, a Financial System Council working group recommended discontinuing quarterly securities filings that have been legally required since 2006 by consolidating them into companies' quarterly earnings releases. Many issues remain to be addressed to finalize the new quarterly disclosure regime's details and ensure its effectiveness.

Financial System Council recommends consolidating quarterly securities filings into quarterly earnings releases

Companies publicly traded in Japan report earnings quarterly. Those whose fiscal year ends on March 31, for example, release interim financial statements dated June 30, September 30 and December 31 in addition to year-end financial statements dated March 31. Japan's Financial Instruments and Exchange Act requires publicly traded companies to disclose certain information in an annual Securities Report filed within three months of fiscal year-end and quarterly reports filed within 45 days of the other three quarter-end dates. In addition to these statutory disclosures, stock exchanges have timely disclosure rules requiring their listee companies to release unaudited financial statements and narrative disclosures promptly after the end of every reporting period.

Previously, publicly traded companies were required to report earnings only semiannually until the Financial Instruments and Exchange Act took effect in 2006. Japan switched from semiannual to quarterly reporting in response to accelerated change in companies' operating environments and increased short-term earnings volatility in the wake of economic globalization.

Quarterly financial reporting has been criticized as a driver of managerial short-termism. Additionally, some commentators have questioned whether its benefits outweigh the costs and red tape it imposes on publicly traded companies, considering that the quarterly earnings releases mandated by stock exchanges are largely identical in content to and roughly coincide timing-wise with statutorily mandated quarterly securities filings.

These concerns were addressed by the Financial System Council's Disclosure Working Group in a report published in June. While the Working Group found no clear link between quarterly financial reporting and corporate short-termism, it recommended that quarterly securities filings be discontinued, with their content incorporated into quarterly earnings releases. Work on the requisite legislative amendment is expected to begin as soon as next spring.

Misconceptions surrounding reform of quarterly financial reporting

Arguments in favor of reforming quarterly financial reporting are based partially on misconceptions. For example, reform proponents cite an August 2018 tweet by then US president Trump calling for a switch from quarterly to semiannual reporting in response to input from "some of the world's top business leaders." Trump's tweet was apparently seen as evidence that even the US, where quarterly reporting originated, is looking to move away from it, but this view is very much mistaken.

In the US, quarterly earnings guidance is typically expressed in terms of EPS. Some publicly traded US companies engage in uneconomic share buybacks to ensure their actual EPS is in line with their publicly disclosed guidance. This practice has been criticized by investors, but few if any market participants are against quarterly financial reporting itself. Even after Trump's tweet, no material changes have been made to US quarterly disclosure practices.

In Europe, an EU directive prohibits national laws mandating quarterly financial reporting. EU countries that previously had statutory quarterly disclosure requirements eliminated them by the mid-2010s. The EU's prohibition is interpreted by some as a repudiation of quarterly disclosure, but this view is likewise a big misconception.

One of the EU's core principles is free intraregional capital mobility. The EU accordingly wants its constituent countries to repeal any national laws that would restrict capital mobility. When regulation is required from a public-interest standpoint, the EU enacts uniform, least-restrictive directives and/or regulations at the EU level.

While information disclosure regimes like quarterly financial reporting are beneficial from an investor protection standpoint, they undeniably impede free capital mobility. If, for example, a company domiciled in a country that requires disclosure of financial statements only annually wanted to raise capital by issuing equity or to just list its shares in a foreign country that requires quarterly disclosure, it would have to meet a higher standard in the foreign country than in its home country.

Since quarterly disclosure was not legally required in all EU countries, the EU issued a directive mandating semiannual disclosure at a minimum. Some European stock exchanges, however, require quarterly financial reporting and some publicly traded companies within the EU voluntarily report their financials quarterly. European companies that want international institutional investors as shareholders report earnings quarterly.

Issues to be addressed

Details of Japan's pending unification of quarterly disclosures have yet to be finalized. Decisions need to be made on a number of key issues.

One such issue is how broadly to apply the requirement to issue quarter earnings releases. Small development-stage companies could conceivably be exempted from the requirement from a compliance cost standpoint. However, given that the quarterly disclosure requirement was first introduced in Japan in the Tokyo Stock Exchange's Mothers Market in the aim of promoting more information disclosure by development-stage companies highly prone to short-term earnings volatility, exempting such companies is probably not appropriate.

Another issue is the content of disclosures in quarterly earnings releases. Quarterly earnings releases were intentionally simplified to minimize duplication with quarterly securities filings. However, if quarterly securities filings are discontinued, quarterly earnings releases would have to be beefed up to include content previously disclosed only in quarterly securities filings.

A third issue is attestation. Quarterly securities filings are currently reviewed by independent auditors whereas quarterly earnings releases are not. A new quarterly review requirement needs to be considered from the standpoint of ensuring disclosed information's reliability.

A final issue is enforcement of compliance, including penalties. Quarterly earnings releases are prepared pursuant to stock exchange rules. Any misrepresentation contained in a quarterly earnings release would not automatically be punishable. Stock exchanges have ways to induce their listees to improve internal controls, including by imposing fines for breaches of listing agreements and placing stocks on watch for potential delisting, but such measures are arguably inadequate.

The Working Group's report proposed providing statutory means of enforcement by designating quarterly earnings releases as interim reports under the Financial Instruments and Exchange Act, in which case misrepresentations would be subject to penalties. Quarterly earnings reports may very well end up being the equivalent of existing quarterly securities filings but with a shorter publication deadline. How to best proceed in this regard is an open question.

In any case, reforming quarterly financial reporting will require a practical approach that seeks to ensure information pertinent to investment decisions is disclosed to investors without imposing an excessive burden on companies.

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