Interpreting Interim Reports

By Michael Kemp

Fifty years ago British Prime Minister Harold Wilson famously quipped that *a week is a long time in politics*. In keeping with this celebrated quote I'd like to suggest that a year is an extremely long time in the business world.

That presents a potential problem for information hungry investors given that, by definition, listed companies only produce an annual report once a year.

Corporate and market regulators, ever keen to protect the investing public, have overcome this potential dearth of financial reporting by requiring that companies supplement their annual report with more regular communication.

This article aims to explain how companies go about delivering more timely information. It then explores one of these, the interim report. It looks at how the interim report differs from the full-year report and, very importantly, how investors can best go about interpreting it.

The ever-changing reporting requirements

First, it is important to realise that the rules dictating financial reporting are constantly changing. The following is a powerful example of how much things can actually change over time.

In 1895 a radical idea was proposed in the United States – that companies distribute annual earnings reports to shareholders. Many responded to the idea with shock and horror, particularly company directors. Here's a typical comment made by a director of the day:

Stockholders should be wholly satisfied in receiving regular dividends and that financial disclosure would likely subject the directors to annoying inquisitions from tax gatherers

Following the 1895 proposal financial reporting by US companies remained optional for many years. It wasn't until the wake of the 1929 Crash that standards were tightened substantially. That's scary stuff when considered in light of today's stringent reporting standards.

Let's now move our focus to Australia.

Keeping the market informed between annual reports

In order to keep the market informed in a timely manner listed companies are required to supplement the information contained in their annual report with financial and operational updates during the course of the year. This is done in two main ways; firstly under the continuous disclosure requirement and secondly through the production of an interim report. Let me explain each.

Continuous Disclosure Requirement

The ASX listing rules require listed companies to continually keep the market informed of any price sensitive news. To quote the ASX listing rules directly: *Once an entity is or becomes aware of any* *information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information.*

Interim Reporting

Listed companies are also required to deliver a set of abbreviated results between annual reports. In Australia these interim results are produced at the half-year mark (i.e. produced midway between annual reports). In the US results are delivered quarterly (hence there are 3 interim reports between each annual report).

What information do interim reports contain?

The most obvious difference between interim and full year reports is that interim reports are much briefer. And while there's nothing stopping a company from providing the same high level of detail and information in its interim report (that it does in its annual report) there is no obligation to do so. So, just like the student who performs his set homework, but no more than that, it's briefer they remain.

But interim reports are still bound by disclosure requirements. An interim financial report must contain, as a minimum, the following components:

- A condensed balance sheet
- A condensed income statement
- A condensed statement showing changes in equity
- A condensed cash flow statement
- Selected explanatory notes.

Interim accounts must also include an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the company since the end of the last annual reporting period.

How else do they differ from the annual report?

Another significant difference, although more subtle, is that while annual reports must be audited it's not a requirement that interim reports are. This isn't surprising given the cost and time involved in undertaking an audit.

An audit provides some comfort to users of financial statements in that it's a detailed process undertaken by a third party (the auditor) to determine whether the financial report is prepared in accordance with the correct framework and applicable accounting standards.

Which begs the question: If interim reports aren't audited can they be trusted?

The answer is: sort of. For starters most companies aim to do the right thing. But secondly they are still checked for their correctness. But it is a lesser form of checking. Rather than being audited interim reports are reviewed. So what's the difference between an audit and a review?

Simply put an audit aims to detect material misstatements and to reduce the risk of fraud. In contrast a review isn't designed to dig as deeply into how the facts and figures making up the reported results were compiled. Therefore the review process doesn't provide the same level of assurance that a financial report is free from material misstatement. A review might unearth a problem but there's no guarantee that it will.

The bottom line is a review doesn't provide the same degree of comfort to statement users that an audit does. So there's a trade-off here. It's a case of the "timeliness" of the information that the interim report delivers over the "reliability" of the information it contains.

Important considerations when interpreting interim reports

When reading an interim report there are a few important things to keep in mind:

1. It is intended to provide an update on the most recent annual report so you should have that annual report handy to refer to as well.
2. Accordingly it focuses on new activities, events, and circumstances that have occurred since the last annual report.
3. There is no requirement for it duplicate information previously reported.
4. The revenue, cash flow and profit figures in an interim report might not be typical of a full years' trading. Many businesses experience seasonal peaks in sales and expenditure. For example retailers and beverage distributors typically earn higher revenues over the summer period. When these situations exist the company is required to highlight this in the report. This should influence how the investor or analyst makes inter period comparisons of corporate performance. Rather than comparing the most recently reported 6 month period with the 6 month period immediately preceding it the comparison should made with the same 6 month period in the previous year (or years), referred to as the prior corresponding period or PCP for short.

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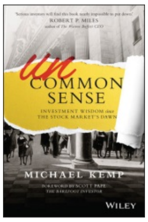

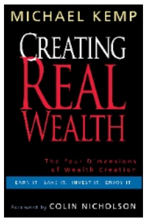

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.