The Regulatory Environment of Compulsory Disclosure of Management Earnings Forecasts in China --- Introductions and Discussions

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Management earnings forecasts (MEFs) are traditionally considered as voluntary disclosures. However, it is a type of compulsory disclosure in China. This paper introduces the evolution of MEF disclosure requirements in China. Further, based on the current Chinese research on MEFs, it investigates companies' forecasting behavior in such an environment. Finally, it discusses the main issues relating to MEF requirements that have attracted many Chinese researchers' attention.

INTRODUCTION

In many countries, management earnings forecasts (MEFs) are voluntary disclosures. A generally accepted definition of MEFs is "Management earnings forecasts are voluntary disclosures that provide information about expected earnings for a particular firm" (Hirst, Koonce, & Venkataraman, 2008). [1] However, this definition cannot be applied in China, because MEF is a type of compulsorily disclosed information in China. According to the listing rules in China stock exchanges[2] and regulations of China Securities Regulatory Commission (CSRC), when listed companies' financial performance or the change of financial performance reaches a certain threshold standard, companies must disclose earnings guidance publicly.[3]

From 1998 to 2006, MEF requirements have undergone a series of amendments and revisions in China, [4] and it is necessary to understand the background and content of these amendments and revisions. Furthermore, Hirst et al. (2008) state that "Although management earnings forecasts are voluntary disclosures, legal and regulatory environment can influence the type of forecasts that firms make and the channels through which they are disseminated".[5] The legal and regulatory environment can influence voluntarily disclosed MEFs, so it is possible that MEF requirements in China may have greater impact on the compulsorily disclosed MEFs. Therefore, it is interesting to investigate the effect of these requirements on Chinese listed companies' MEF disclosure. The reform of MEF system in China is now in its preliminary stage, so there is still much work to do to improve MEF disclosure and many Chinese researchers propose their own suggestions. Therefore, it is necessary to examine, conclude and discuss these research results.

This paper contributes to research on MEFs and regulators in the following ways: First, MEFs are traditionally considered as voluntary disclosures. Therefore, it is interesting for international researchers to be introduced to a regulatory environment where MEFs are compulsory disclosures, and also understand companies' forecasting behavior in such an environment. Second, it is informative for Chinese regulators about whether companies comply with MEF requirements well, and what they need to do to improve the MEF regulatory environment. Last, it is also informative for regulators and researchers in other developing countries about the benefits and drawbacks of the regulatory environment of compulsory MEF disclosure in an emerging market, and may help them make decisions or put forward suggestions regarding MEF regulations in their countries' emerging securities markets.

The rest of this paper is organized as follows. Section one introduces the background and content of the amendments and revisions in relation to MEF requirements in China from 1998 to 2006. Section two summarizes how listed companies comply with MEF requirements based on the statistics of current Chinese MEF research. Section three provides conclusions of and discussions about current researchers' views regarding how to improve the regulatory environment of MEFs in China. The final section makes conclusions of this paper.

MEF SYSTEM IN CHINA

MEF Requirements

Currently there are four types of MEFs issued by Chinese listed companies, including forecasts of losses, forecasts of changes from profits[6] to losses, forecasts of large earnings increases, and forecasts of large earnings decreases.[7] These four types of MEFs are not introduced into China MEF system at the same time. The development of MEF system is a process of gradual evolution.

Prior to 1998: No Compulsory Forecast Requirement

Compared to developed countries, securities markets in China developed late. In December 1990 and June 1991, Shanghai Stock Exchange and Shenzhen Stock Exchange were respectively established. In the first a few years many listed companies provided annual earnings forecasts for the next year in their annual reports, but there were no laws or regulations relating to MEFs. However, because of lack of regulations and supervision, a large proportion of these forecasts are not very accurate. Therefore, CSRC prescribed regulations in relation to MEFs. Then in order to avoid troubles relating to MEF disclosure, most companies stopped issuing earnings forecasts, and only IPO companies were required to provide earnings guidance.

However, in the following years, CSRC began to consider MEF disclosure for the following reasons. First, Chinese listed companies do not have many incentives to release earnings guidance voluntarily, [8] so most of the time investors cannot know firms' exact results until the announcement of periodic reports.[9] Second, some big investors (such as institutional investors) get information about firms' future earnings privately from managers, and then make profit or avoid losses from stock trading. However, many medium and small investors who are inaccessible to this private information always get losses in such situations. Third, the balance date of all the Chinese listed companies is 31 December, so the dates of periodic reports of Chinese listed companies are quite close to each other. Therefore the volatility of stock prices is quite violent during the earnings announcement periods, especially the period of annual report disclosure.

1998-2000: Introduction of Annual Forecasts of Losses

Since December 1998, earnings warnings regulation has been implemented. Under such a regulation, at the end of the financial year companies expecting three consecutive years of losses or material losses in the current year must disclose timely earning warnings. [10] The purpose of this regulation is quite obvious, that is, to reduce the volatility of stock prices when annual reports are announced. However, it was quite rough, and did not provide specific explanations, such as the standard of "material losses", and the horizon of earnings warnings disclosure. This earnings warnings requirement was recognized by market participants, and it was continued in 1999. [11]

In 2000, the regulation further set out the horizon and times of earnings warnings disclosure, and defined forecasting companies as all companies expecting losses. Under such a regulation, companies expecting losses must disclose earnings warnings in two months after the end of the financial year; companies expecting three consecutive years of losses must disclose earnings warnings for three times in two months after the end of the financial year. [12]

2001: Introduction of Half Yearly Forecasts and Forecasts of Earnings Increases/Decreases

Until 2000, compulsorily disclosed MEFs are restricted to only annual forecasts of losses. In the early July of 2001, half yearly forecasts and forecasts of earnings decreases were introduced into China MEF system. According to the listing rules, companies expecting losses or large earnings decreases for the first half must disclose earnings warnings in one month after the end of the first half year. [13] However, it did not explain what "large earnings decrease" is. On 6 July 2001, Jilin Chemical Fiber (code 000420) became the first company disclosing forecasts of earnings decreases after the introduction of the above MEF listing rules, and its stock prices declined significantly after the disclosure.

In December 2001, Shanghai and Shenzhen stock exchanges further prescribed listing rules regarding MEFs. Under these rules, in addition to companies with losses, firms with large earnings increases or decreases (changes of total profit equaling to or in excess of 50% compared to last year) must disclose earnings guidance in 30 days after the end of the financial year. The regulation also provides exceptions where companies do not need to provide earnings guidance. [14]

2002: Introduction of Quarterly Forecasts

Before 2002, MEFs disclosed by Chinese listed companies are actually earnings preannouncements because they are disclosed after the end of the financial period. From 2002, forecast timeliness of Chinese companies has been further improved. According to the requirements issued by Shanghai and Shenzhen stock exchanges, if companies expect losses or large earnings changes (changes of net profit equaling to or in excess of 50% compared to the corresponding period of last year) in the next reporting period, they must issue earnings guidance in the periodic reports of this reporting period. [15]

2003-2005: Introduction of Forecast Revisions

From 7 January 2003 to 29 December 2006, the two stock exchanges pay more attention on MEF revisions. The listing rules prescribed that if companies expected losses or large earnings changes in the next reporting period but did not provide earnings guidance in periodic reports of the last financial period, or expected prior forecasts would diverge from the actual results, they must provide forecasts or forecast revisions as soon as possible.[16]

2006: Introduction of Forecasts of Profits

In July 2006, Shenzhen Stock Exchange issued new rules, which prescribed that companies expecting losses, changes from losses to profits (compared to the corresponding period of last year), or large earnings changes for this or next reporting period must disclose timely earnings guidance.[17] Therefore, from 2006 Chinese MEF system includes forecasts of four types: forecasts of losses, forecasts of profits, and forecasts of large earnings increases and decreases. Further, companies need to disclose earnings guidance as soon as they realize the above four types of earnings information, no matter through routine or non-routine reports. The change of forecast rules and regulations in recent years is outlined in Table 1.

TABLE 1
CHANGE OF MEF REQUIREMENTS

Year	Forecast Content	Forecast Type	Forecast Time
Dec.1998-Dec.2000	losses	annual forecasts	after the balance date
Jul.2001	+ large earnings decreases	+half yearly forecasts	Before 31 Jul.
Dec. 2001	+large earnings increases		
Mar.200-Dec. 2002		+quarterly forecasts	Periodic reports of the last financial period
May 2006	+ forecasts of changes from losses to profits		report timely
+ indicates the introduction of new forecast content or types			

Summary of Changes of MEF Requirements

Following the amendments and revisions of MEF requirements, both MEF frequency and quality have improved. From the above section, the following summaries of changes of MEF requirements are made:

First, forecast frequency has been improved. Before 2001, firms were only required to provide annual earnings forecasts, in 2001 companies also needed to provide forecasts for the first half year, and from 2002 firms were required to provide earnings forecasts for the next quarter in the current quarterly reports.

Second, forecast horizon has become shorter. Taking annual forecasts for example, before 2002 companies were only required to disclose annual earnings forecasts after the end of the financial year, but from 2002 companies needed to disclose annual earnings forecasts in the third quarterly reports, and from 2006 firms were required to disclose earnings forecasts timely when they realized they should disclose earnings guidance.

Third, the type of MEFs has increased. Before 2001, firms only needed to provide forecasts of losses; from 2001, they were required to disclose both forecasts of losses and large earnings increases/decreases; in 2006, companies were also required to provide earnings guidance when they expected changes from losses to profits.

Differences of MEF Requirements between China and Developed Countries

Because of the late development of securities markets and also the different economic and even cultural environment in China, MEF requirements in China are quite different from those of developed countries (such the U.S., Australia and New Zealand, etc.) where information disclosure requirements are more mature.

First, the nature of MEFs is different. In the U.S. and many other countries MEF disclosure is voluntary. However, in China if companies' financial performance or the change of financial performance reaches a certain standard, they must disclose earnings guidance. Of course, other companies can also voluntarily disclose earnings forecasts if they want. Therefore, MEF disclosure in China is compulsory, or more precisely, half-compulsory. Some researchers (He, Wang, & Wang, 2002; Liang, 2005) state that in such a new securities market where companies have few incentives of disclosing forecasts and serious information asymmetry exists between large and small investors, the implementation of compulsory MEF requirements is necessary.

Second, the comparison standard is different. In the U.S. and many other developed countries, if companies expect their actual earnings will deviate from market earnings expectations, they may disclose earnings guidance. Market earnings expectations are usually measured by the current analysts' earnings forecasts in the U.S. However, in China the comparison standard is earnings in the corresponding financial period of last year. This is because analysts' forecasts are developed quite late in China, and even now there are not enough analysts' forecasts to form market earnings expectations.

MEF DISCLOSURE IN CHINA

In such as a compulsory disclosure environment of MEFs, do companies follow these forecast requirements well? In this section we examine the likelihood and characteristics of MEFs issued by Chinese companies based on the current research.

Forecast Likelihood

According to Zhang and Zhang (2011), from 2001 to 2008, among listed companies which should disclose MEFs according to the requirements, nearly 50% of them did not disclose any earnings guidance. Further, among the 10,864 MEFs disclosed by sample companies, 11.7% are disclosed voluntarily by companies which do not need to disclose earning guidance according to the requirements. The large proportion of companies violating disclosure requirements is probably due to the low costs of contraventions, which will be discussed in the next section.

Forecast likelihood differentiates between good and bad news forecasts.[18] Du (2009) examines MEFs disclosed from 2003 to 2007, and finds among no matter compulsorily or voluntarily issued MEFs, companies are more inclined to disclose good news forecasts. Wang (2009) also finds the same results when examining annual MEFs of 2007 disclosed by listed companies in Shenzhen Stock Exchange. She finds some companies which should disclose earnings warnings actually withhold bad news, while all the companies which should issue good news provide their earning guidance following the requirements. The smaller proportion of bad news forecasts compared to good news is probably because the costs (litigation risk, reputational costs, etc.) of withholding bad news forecasts are not significantly higher than those of withholding good news in China, which is different from the U.S. (Skinner, 1994).

Forecast Characteristics

Although MEF disclosure is compulsory for some listed companies in China, firms still have much discretion on the attributes of their forecasts. Zhang (2002) examines the accuracy of annual MEFs of 2001, and finds that 84.97% of these forecasts are accurate. Further, Yang (2010) finds among MEFs disclosed from 2006 to 2008, 84% are accurate. The high proportion of accurate MEFs disclosed by Chinese listed companies is probably due to the low precision of these forecasts. Regarding forecast precision, Zhang (2002) states that in his sample MEFs, most are qualitative forecasts. However, he did not tell people the exact proportions of qualitative and quantitative forecasts. Further, Li (2008) finds only 38.68% of the 2,955 MEFs disclosed from 2003 to 2005 are quantitative forecasts.

For the attributions accompanying MEFs, many researchers (He, 2004; Wang, 2009; Zhang, 2002) state the attributions are not informative enough. Managers tend to attribute good news to internal reasons, while attribute bad news to external reasons; further, the attributions are too simple.

Another attribute that has attracted many Chinese researchers' attention but has not been studied in other countries is called "changing faces" by Chinese researchers. "Changing faces" is actually a type of forecast revisions, but it refers to revisions changing inversely compared to the last forecasts, such as, changes of forecasts of losses (profits) to profits (losses), or changes of forecasts of earnings increases (decreases) to decreases (increases). "Changing faces" seriously influences investors' confidence in securities markets, and also results in volatility of stock prices (Lin, 2003). Chinese listed companies' frequent "changing faces" is probably due to the lack of laws or regulations relating to MEFs, and therefore the low costs regarding companies' improper forecasting behavior.

Summary

In summary, since the establishment of MEF system in China, more and more Chinese listed companies have begun to provide earnings guidance, which effectively reduces the information asymmetry between management and investors (Dai, Mao, & Yao, 2005). However, from the brief review of current research on MEFs in China, it is obvious that there are still some companies that should provide MEFs but withhold their earnings news, especially bad news. Further, although some companies disclose their earnings guidance following the requirements, the quality of their forecasts is not very high (low precision, attributions with little information content, and "changing faces", etc.).

DISCUSSIONS ABOUT MEF SYSTEM IN CHINA

Researchers (Dai et al. 2005; Lin, 2003) find MEFs disclosed by Chinese companies have information content, and they can reduce the information asymmetry between management and investors. Therefore, they agree that MEF system is necessary in China securities market, and CSRC should do more work to encourage companies to disclose MEFs. Further, researchers discuss how to improve both the quantity and the quality of MEFs disclosed by Chinese listed companies.

MEF Requirements

The basis of the current MEF system is the rules of stock exchanges, like notices relating to annual/half yearly/quarterly reports and guidance. The effect of these temporary rules is not durable, and the content has changed frequently these years. Further, Shanghai and Shenzhen stock exchanges respectively issued their own notices or guidance regarding MEFs. Therefore, companies' MEF disclosure behavior over time and between companies is not very consistent. Researchers (Lin, 2003; Wang, 2009) suggest including MEF disclosure into securities laws and regulations, which may improve the consistency of companies' forecasting behavior.

Taking Australia for example, according to ASX *Listing Rule 3.1* (*LR 3.1)*, once companies realize material information, they must immediately disclose it to Australia Securities Exchange (ASX). According to Guidance Note 8, one disclosure example of *LR 3.1* is the earnings forecast variation in excess of 10% to 15% from the market earnings expectation. The disclosure rules also get statutory backing from *Corporations Act*, which enhances the authority of the listing rules. In China, from 2006 MEF requirements have become more mature and durable. The required four types of forecasts (forecasts of losses, profits, large earnings decreases and increases) cover most of the earnings changes investors are most concerned about, and companies are required to disclose timely earnings guidance as soon as they realize their financial performance has reached the standard of compulsory forecasts. Therefore, it is time to put these forecast requirements into securities laws, or provide statutory support for these forecast requirements.

Enforcement of MEF Requirements

Formulating MEF laws is just the first step. Golding and Kalfus (2004) state that the vigor of enforcement is the key to the effective regulation of disclosure requirements, and this view can also be applied to MEF requirements in China. According to Song (2009), among the 947 sample companies violating forecasting rules and regulations from 2001 to 2007, only 67 samples (7.08%) received punishment. They further find companies receiving punishment are always those with worse financial performance.[19] If companies realized that they were seldom punished after contraventions of disclosure requirements, more and more companies would choose to violate the requirements for their own benefits (Lin, 2003).

Costs of Contraventions of MEF Requirements

Even if all the companies receive punishment for their contraventions of disclosure requirements, the low costs still cannot prohibit their future violations. In China securities markets, when companies violate information disclosure requirements, most of the time the punishment they receive from CSRC or stock exchanges is public censure (Li, 2005), which cannot behave as an effective deterrence for firms' future violations. Song, Li and Ji (2011) finds companies receiving punishment for contraventions of MEF rules do not improve their following forecast behavior. Song et al. (2011) state that is probably due to the ineffective enforcement of MEF requirements and low costs of violating the requirements. Therefore, increasing the costs of contravening MEF requirements is an effective method of decreasing the probability of contraventions (Lin, 2003).

Further, some researchers (Lin, 2003; Zhang and Zhang, 2011) point out that class action is an important supplement to the supervisions of CSRC and stock exchanges.[20] Class actions can effectively increase companies' costs of violating MEF requirements. If companies lose the lawsuits, they will incur losses of both money and reputations.

Other Issues

According to the forecast requirements, companies with earnings changes equaling to or in excess of 50% must provide earnings guidance. However, some researchers (Lin, 2003; Tong, 2003) ask: why is the disclosure threshold 50%, not 40%, 30%, or 20%? Actually CSRC and the two stock exchanges do not provide any explanations for the threshold standard of 50%. Some researchers (Lin, 2003; Tong, 2003; Yang, Shan, Cao, and Fu, 2002) argue that the 50% standard is too high, and earnings changes less than 50% may also result in large stock price volatility. Therefore, they suggest decreasing the forecasting threshold to 35% (Yang et al., 2003) or 30% (Tong, 2003). However, these researchers also do not provide any explanations for their suggested standard.

Australia's Guidance Note 8 prescribes that an expected earnings change of more than 10% is considered as material information, so companies becoming aware of an earnings variation in excess of 10% to 15% from the market earnings expectation must disclose earnings guidance immediately. Therefore, when discussing the forecasting threshold standard in China, it is a good method to consider the international standard.

Another issue that researchers discuss much is leak of earnings news before forecast announcements. Research (Tong, 2002; Yang, 2010) on the market reaction to MEFs finds that in China earnings forecast news, especially bad news forecasts are always leaked before the announcement of MEFs. Researchers argue that many big investors (mainly institutional investors) can get insider information about firms' future earnings in advance from management, and make profit or avoid losses from stock trading. However, the medium and small investors are always those who can only know that information later and get losses. In 2007, CSRC issued *Management of Information Disclosure of Listed Companies*, which introduced the principle of "fair disclosure". This regulation prescribes that companies must disclose information to all the investors at the same time.[21] However, the effectiveness of this regulation has not been studied by Chinese researchers.

CONCLUSION

MEF is a type of voluntarily disclosed information in many countries. However, in China it is a type of compulsory disclosure. If companies' financial performance or the change of financial performance reaches a certain threshold standard, they must disclose earning guidance timely. Compared to developed countries, China MEF system was developed late. From 1998 MEF requirements in China have undergone a series of amendments and revisions. This paper introduces the evolution of MEF requirements from 1998 to 2006, and companies' MEF disclosure based on the current Chinese research. Further, the current MEF system is still not mature enough, and researchers provide many suggestions regarding the improvement of MEF requirements. Based on these suggestions, this paper discusses the main issues that has attracted regulators' and many researchers' attention.

This paper introduces the regulatory environment of compulsory MEF disclosure that is different from most countries where MEF disclosure is voluntary, which may be interesting for many international researchers. For regulators in China, this paper is informative about the implementation of MEF requirements, and what need to do to improve the MEF system. For regulators in other developing countries, this paper is informative about the effects and problems of the regulatory environment of compulsory MEF disclosure in an emerging market.

ENDNOTES

1. See Hirst et al. (2008, p. 315).
2. Shanghai Stock Exchange and Shenzhen Stock Exchange.
3. The terms *management earnings guidance* and *management earnings forecasts* are used interchangeably in this paper.
4. In this paper, the combination of MEF listing rules and regulations is called MEF requirements.
5. See Hirst et al. (2008, p. 321).
6. It refers to profits in the corresponding period of last year.
7. Earnings increases and decreases refer to increases and decreases from earnings in the corresponding period of last year.
8. That is probably because the competition for capital in Chinese capital market is not so fierce, especially for state-owned companies who enjoy priority when raising capital because of their close relationships with the government. Further, most of the time companies are not punished for withholding earnings guidance even when their earnings change significantly.
9. Taking one Chinese listed company (code 600898) for example, in 1998 in its half yearly report it announced that is EPS was 0.075 yuan, and in its annual report its EPS decreased to -2.543 yuan. During the period from the disclosure of the half yearly report to its annual report disclosure, there were not earnings warnings. Many investors were shocked when the annual results were announced.
10. See paragraph 3 of *Notice of Preparation for the 1998 Annual Report of Listed Companies* issued by CSRC.
11. See paragraph 8 of *Notice of Preparation for the 1999 Annual Report of Listed Companies* issued by CSRC.
12. See paragraph 19 of *Notice of Preparation for the 2000 Annual Report of Listed Companies* issued by Shanghai Stock Exchange, and paragraph 23 of *Notice of Preparation for the 2000 Annual Report of Listed Companies* issued by Shenzhen Stock Exchange.
13. See paragraph 5 of *Notice of Preparation for the 2001 Half Yearly Report of Listed Companies* issued respectively by Shanghai Stock Exchange and Shenzhen Stock Exchange.
14. Companies with small comparison base (commonly referred to companies with absolute annual EPS less than 0.05 last year) do not need to disclose earnings guidance.
15. In China companies need to provide periodic reports quarterly. For the disclosure requirements see *Notice of Preparation for the 2002 First Quarterly Report of Listed Companies, Notice of Preparation for the 2002 Third Quarterly Report of Listed Companies,* and *Notice of Preparation for the 2002 Half Yearly Report of Listed Companies* issued respectively by Shanghai and Shenzhen stock exchanges. In addition to the exceptions prescribed in 2001, companies with absolute EPS less than 0.03 yuan in the first half of last year also do not need to disclose MEFs.
16. See *Notice of Preparation for the 2003 Half Yearly Report of Listed Companies, Notice of Preparation for the 2003 Third Quarterly Report of Listed Companies,* and *Notice of Preparation for the 2003 Annual Report of Listed Companies* issued respectively by Shanghai and Shenzhen stock exchanges.
17. *See paragraph 4 of NO. 1 Guidance of Information Disclosure of Listed Companies--Earnings Preannouncement and Preliminary Report* issued by Shenzhen Stock Exchange. In addition to the forecast exceptions prescribed in the prior years, companies with absolute EPS less than 0.04 yuan in the last third quarter also do not need to disclose earnings guidance.
18. From 2006, there are four types of MEFs in China, including forecasts of losses, forecasts of changes from losses to profits, forecasts of earnings increases, and forecasts of earnings decreases. Forecasts of losses and earnings decreases are bad news forecasts, and forecasts of profits and increases are good news forecasts.
19. There are mainly four types of behavior violating MEF rules and regulations: withholding forecasts, late forecasts, changing faces, and inaccurate forecasts.
20. Currently there is no class action in China.
21. See paragraph 3 of Chapter 1 of *Management of Information Disclosure of Listed Companies.*

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