

# **LISTED COMPANIES' PROFIT WARNINGS: WHICH WAY FOR UGANDA?**

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## 1.0 Background

Investors who participate in the capital markets usually make investment decisions based on the information that is available to them.<sup>1</sup> They rely on the information on earnings in determining whether to buy, hold or sell securities of a particular company. On the other hand, management is assigned to operate a company efficiently and to report the results in financial statements to its shareholders in a timely manner. Transparency should exist in the market so that investors can make rational and well-informed decisions when allocating their capital. If a company misleads investors about its future prospects, it will be difficult for investors to make informed decisions.<sup>2</sup> Therefore, accurate and timely information disclosure from companies is essential.

Sometimes the companies' performances fall short of expectations and past performances. Leading up to earnings announcements, companies should be aware of the looming outcome. Profit warning<sup>3</sup> disclosures usually result in negative market responses for the shares of these companies. Nevertheless, many companies choose to publish profit warnings in order to avoid potential legal challenges, retain the trust of investors in the long-term and avoid potentially larger declines in the stock price when the earnings are announced. Furthermore, profit warnings create a clear benefit to the capital market through among other things, reducing information asymmetry<sup>4</sup>, protecting interests of the investors, building investors' confidence in the capital markets and correcting market expectation regarding overvalued firms.<sup>5</sup>

The Uganda Securities Exchange (USE) listing rules, 2003, have a requirement for disclosure of price sensitive information which is likely to have material effect on the financial results of an issuer, but do not state the percentage drop on earnings above which listed companies should issue profit warnings. Because of the vague requirement, listed companies in Uganda have not been issuing profit warnings, impeding the accurate and timely information disclosure that is essential for the capital market to work efficiently. Therefore, in order to build orderly, fair and efficient markets to better serve the long term capital needs of both the public and

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<sup>1</sup> Amer, A. A. J., Wijaya, K. R., Khairul, H. P., & Dayang, S. A. B. (2014). Making Style and Investment Success of Retail Investors in Malaysia. *International Journal of Business and Social Science*, Vol. 5, No. 9(1).

<sup>2</sup> Tserendash, T., & Xiaojing, W. (2010). *The relationship between the profit warning and stock returns: Empirical evidence in EU markets*. (Master Thesis). Umeå, Sweden: Umeå School of Business.

<sup>3</sup> Profit warnings are the discretionary disclosure of bad news by companies prior to earnings announcements

<sup>4</sup> Information asymmetry, also known as information failure, occurs when one party to an economic transaction possesses greater material knowledge than the other party.

<sup>5</sup> Tserendash, T., & Xiaojing, W. (2010). *The relationship between the profit warning and stock returns: Empirical evidence in EU markets*. (Master Thesis). Umeå, Sweden: Umeå School of Business.

private sectors, the USE listing rules should be amended to compel listed companies to publish profit warnings. These profit warnings should be issued as soon as the listed companies are aware that there is a high likelihood of lower profits.

## 2.0 Profit Warnings

Profit warnings are the discretionary disclosure of bad news by listed companies prior to earnings announcements.<sup>6</sup> These statements are issued by companies due to changes in their financial results. They are published to inform investors and stakeholders about the companies' operating performance and to alert them about deviations from forecasted earnings or market expectations. In most developed markets listed companies issue earnings forecasts. This is not the case in most developing countries, Uganda inclusive. However, there are some stock brokers that publish research reports which provide estimated earnings projections and target prices for the locally listed companies. In Uganda listed companies publish half-year unaudited earnings reports and full-year audited reports.

### 2.1 Circumstances under which Profit Warnings are issued

Profit warnings are usually issued by companies that anticipate a forthcoming earnings outcome that will be significantly below forecasted earnings or market expectations. Companies in developed markets often disclose profit warnings based upon revised earnings projections, but the companies are also inclined to disclose a statement if they are aware of differing market expectations regarding the future performance of the company.<sup>7</sup>

Ugandan listed companies currently do not publish earnings forecasts and measuring market expectations would be flawed considering the limited number of broker forecasts. In addition, the extent to which listed companies in Uganda prepare internal earnings projections is unknown since they are not required to publish them. It would therefore be problematic to stipulate Ugandan listed companies to issue profit warnings based on forecasts or market expectations. Recognizing this problem, other developing markets, such as South Africa, Kenya and Tanzania require listed companies to issue profit warnings based on their previous year's earnings.

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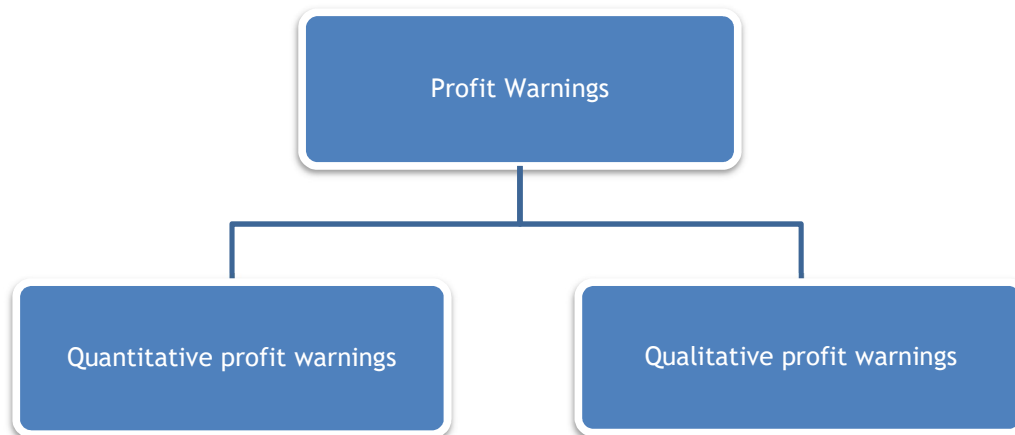
<sup>6</sup> Bulkley, G., Harris, R. D. F., & Herrerias, R. (n.d.). *Stock Returns Following Profit Warnings: A Test of Models of Behavioural Finance*. Exeter, United Kingdom: University of Exeter

<sup>7</sup> Kristoffer, S., & Eivind, D. (2013). *The Information Content in Profit Warnings and the Implications for Market Rationality*. (Master Thesis). Oslo, Norway: BI Norwegian Business School

## 2.2 Types of Profit Warnings

The profit warnings are classified into two types, based on the content and scope of the profit warnings.<sup>8</sup>

**Figure 1. Categorization of Profit Warnings**



Source: Tserendash, T., & Xiaojing, W. (2010). *The relationship between the profit warning and stock returns: Empirical evidence in EU markets. (Master Thesis)*. Umeå, Sweden: Umeå School of Business.

### a) Quantitative profit warnings

These profit warnings provide detailed forecasts and show the exact number of earnings estimates or an expected change in forecasted earnings. That is, quantitative profit warnings offer numbers regarding the earnings.

### b) Qualitative profit warnings

These profit warnings state or indicate that earnings will fall below the forecasted earnings or market expectations without offering a specific estimation of the new earnings. Qualitative profit warnings only present a downward tendency statement.

As Ugandan listed companies currently do not issue earning projections, it would not make sense to require them to issue quantitative profit warnings. With this in mind, any profit warnings rule in Uganda should only mandate a qualitative statement.

As the Ugandan market however develops and listed companies start to issue earnings forecasts, this should be reconsidered.

<sup>8</sup> Tserendash, T., & Xiaojing, W. (2010). *The relationship between the profit warning and stock returns: Empirical evidence in EU markets. (Master Thesis)*. Umeå, Sweden: Umeå School of Business.

### **3.0 Rationale for Companies to Issue Profit Warnings**

Listed companies choose to issue profit warning due to several reasons that are discussed in the section that follows.<sup>9</sup>

#### **3.1 Prevention of stock prices from dramatic decline**

Profit warnings issued by companies help to reduce the impact of forthcoming earnings announcements by informing and preparing investors. Thus, they attempt to lower the market reaction in the stock prices and prevent even larger stock price fluctuations. Profit warnings give information that companies' projected earnings will change, thus investors should revise their expectation and re-consider their decisions of buying, selling or holding the stock.

#### **3.2 Legal liability and threat of legal actions**

Failure to disclose bad news or issue profit warnings may lead to shareholders taking legal actions. To this end, profit warnings can be utilized to avoid legal actions as they provide investors with the necessary information to correct market expectations.

#### **3.3 Reputation and communication**

Profit warnings issued by companies help maintain good relations with investors and the company's reputation and image in the market. Disclosures of information are an important tool of communication with the investment community and listed companies particularly pay attention to maintaining good communication and relationship with institutional investors which are often large stock holders and their trading decisions have an influence on other investors. Furthermore, when investors lose trust in a company or its management they might refuse to hold the stock or require a higher expected return in order to compensate for the additional risk from the negative reputation caused by previous misleading information on earning expectations. This would result in higher financing costs for companies.

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<sup>9</sup> Tserendash, T., & Xiaojing, W. (2010). *The relationship between the profit warning and stock returns: Empirical evidence in EU markets*. (Master Thesis). Umeå, Sweden: Umeå School of Business.

#### **4.0 Current USE Rules Requirement on Disclosures**

The USE listing rules, section 38 of the general obligations for disclosure states that, an issuer should release an announcement giving details of the circumstances or events that have or are likely to have material effect on the financial results, financial position or the cash flow of the issuer. Additionally, the issuer should also disclose information necessary to enable holders of its listed securities and the public avoid the creation of a false market<sup>10</sup> in its listed securities. The rules state that the announcement shall be made as soon as possible, but not later than twenty-four hours following the circumstance or event.

Appendix 4 of the USE listing rules further states that information to be disclosed should include, but not be restricted to any major development in the issuers' sphere of activity or expectations of performance which is not public knowledge which may lead to substantial movement in the price of its securities.<sup>11</sup>

It is noteworthy that the current rules do not define what a major development means and do not state the percentage drop on earnings which should compel the listed companies to issue profit warnings. Therefore, Ugandan companies do not tend to issue profit warnings even if the above rule should mandate them to do so. This shows that the current USE listing rules are too vague and should be amended.

#### **4.1 Current CMA Regulation on Continuous Disclosures**

The CMA Act under section 90AD states that, every issuer of securities that are a subject of a public offer should notify the stock exchange about information relating to the issuer and its subsidiaries if any, that might reasonably be expected to materially affect market activity in its securities or its subsidiaries'. It further states that any information that might reasonably be expected to affect market activity in the price of its securities should also be disclosed.

Again, there is no definition in the CMA Act what materiality means and the percentage drop in earnings which should compel the listed companies to issue profit warnings.

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<sup>10</sup> A false market occurs when prices are manipulated and impacted by incorrect information, preventing the efficient pricing.

<sup>11</sup> The Uganda Securities Exchange listing rules, 2003.

## 5.0 Circumstances and Issuance Procedures in other Jurisdictions

Different countries have varying approaches for issuing profit warnings. The following are some of the regulatory approaches in selected jurisdictions for the issuance of profit warnings:

### 5.1 Kenya

The Capital Markets Securities Public Offers Listing and Disclosures Regulations 2002 and as amended 2016 under the continuing obligations section, state that an issuer should disclose all material information<sup>12</sup> and make a public announcement of any profit warning, where there is a material discrepancy between the projected earnings for the current financial year and the level of earnings in the previous financial year. The regulations continue to state that material discrepancy in relation to projected earnings for a financial year means that such earnings are at least twenty-five percent (25%) lower than the level of earnings in the previous financial year.<sup>13</sup> The profit warnings issued by listed companies in Kenya are a hybrid of qualitative and quantitative warnings, but are categorized under qualitative profit warnings.

Furthermore, the regulations say that unless otherwise stated, all public announcements which an issuer is required to make shall be made within twenty-four hours of the happening of the event.

### 5.2 Tanzania

The Dar es Salaam Stock Exchange Rules, 2016 under the continuing listing obligations section state that an issuer should notify the exchange of any price sensitive information which could materially impact the price of its securities at the exchange. Price sensitive information includes, but is not limited to situations where expected quarterly performance is below twenty-five percent (25%) compared to the previous period performance.<sup>14</sup>

### 5.3 Sri Lanka

The listing rules of the Colombo Stock Exchange (CSE) under the corporate disclosure section state that the CSE does not normally consider disclosure of an entity's internal earnings projections or other data relating to its affairs to be necessary. If such estimates or projections are released, they should be prepared carefully, on a reasonable factual basis, and should be stated realistically with appropriate qualifications. The listing rules further state that should subsequent developments

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<sup>12</sup> Material information means any information that may affect the price of an issuer's securities or influence investment decisions.

<sup>13</sup> The Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002.

<sup>14</sup> The Dar es Salaam Stock Exchange Plc Rules, 2016.

indicate that actual performance will not be reflective of prior estimates or projections, then this should be reported with explanation of the reasons for the variance. This information is considered to be price sensitive.<sup>15</sup> The profit warnings requirement is qualitative, however as in the other jurisdictions, companies may choose to disclose more information and issue a quantitative profit warning.

#### **5.4 South Africa**

The Johannesburg Stock Exchange Limited listings rules state that all issuers, other than those who publish quarterly results, must publish a profit warning. The profit warning should be published as soon as the issuer is satisfied that a reasonable degree of certainty exists that the financial results for the period to be reported upon next will differ by at least twenty percent (20%) from the most recent financial results. Issuers may publish a profit warning if the differences referred to above are less than 20%, but which are viewed by the issuer as being important enough to be made the subject of a profit warning.<sup>16</sup> Furthermore, in the event of an issuer publishing a profit warning, the issuer must either produce and submit to the JSE a profit forecast or estimate and accountant's report thereon or include a statement (which is not deemed to be a cautionary statement and which does not give rise to the commencement of a closed period) in the profit warning advising securities holders that the forecast financial information has not been reviewed and reported on by the issuer's auditor.

On the other hand, the rules state that issuers with a policy of publishing quarterly results must instead include a general commentary in each quarterly results announcement. This ensures that shareholders are guided on the expected performance of the issuer for the next quarter (which may be as detailed or broad as the issuer chooses) and the issuer may also decide to issue profit warnings on a voluntary basis.

#### **5.5 Lessons for Uganda from other Jurisdictions**

Sri Lanka's profit warning regulations are closest to those of Uganda as they do not stipulate when exactly a profit warning should be issued. This in Uganda's case is clearly not working as Ugandan listed companies do not tend to issue profit warnings even if their profits fall significantly. However, the Sri Lankan regulations stipulate that if earning projections are issued, they should be carefully prepared and issued with appropriate qualifications. As the Ugandan market becomes more developed, listed companies should be encouraged to issue earnings forecasts and therefore, the

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<sup>15</sup> Colombo Stock Exchange Listing Rules.

<sup>16</sup> Johannesburg Stock Exchange Limited Listings Requirements.

new listing rules should be drafted with that in mind.

South Africa requires listed companies to issue a profit warning if the financial results differ by at least 20% from the most recent financial results. Tanzania and Kenya, both EAC countries have similar rules, but only require a profit warning if the results differ by 25%. These rules clearly give guidance on when companies should issue profit warnings and result in better legal enforceability than the current Ugandan rules.

Additionally, the JSE rules require that in the event of an issuer publishing a profit warning, the issuer must either prepare and submit a profit forecast and accountant's report thereon or include a statement in the profit warning advising securities holders that the forecast financial information has not been reviewed and reported on by the issuer's auditor. This requirement would impose an undue burden on USE listed companies, but as the Ugandan market becomes more developed, listed companies should be encouraged to issue earnings forecasts.

Therefore, Uganda should consider adopting similar profit warning regulations as Kenya and Tanzania. However, none of these regulations stipulate any rules for when companies issue earnings forecasts, something that Uganda should consider doing to avoid having to amend the rules again when companies start issuing earnings forecasts.

## **6.0 Recommendation for Amendment of USE Rules**

The quantitative profit warnings which provide precise figures apply more to companies that publish earnings projections. Listed companies in Uganda don't publish any earnings forecasts. Despite qualitative profit warnings being more sensitive to price fluctuations since they only offer a downward tendency statement, the Uganda Securities Exchange should adopt this type of profit warning with a stated minimum percentage drop in profits compared to a previous year's profit, above which listed companies should issue a warning. The USE rules should be amended to include provisions for mandatory qualitative profit warnings.

After analyzing the previous performances of only locally listed companies over the years (see table below), we propose that this percentage be set at 25 percent. The analysis concentrated only on locally listed companies since the companies cross-listed with the Nairobi Stock Exchange already have a profit warning requirement set at 25% as part of their continuous listing obligations, which has not been an undue burden on them.

Setting the percentage at 25% would not impose an undue burden on the locally listed

companies as on average only 22.77% of them would have had to issue a profit warning since 2010. Furthermore, there is no large difference in the number of companies that would have had to issue profit warnings using the different percentages as shown in Table 1.

**Table 1: USE locally listed companies that would have had to issue a Profit Warning between 2010 to 2017 (assuming a minimum requirement of a 20%, 25% and 30% drop in profits)**

	2010	2011	2012	2013	2014	2015	2016	2017
20%	4	0	2	3	1	1	2	2
25%	4	0	2	2	1	1	2	2
30%	4	0	2	2	1	1	2	2
Total number of local listed companies	7	7	8	8	8	8	8	8

Source: CMA Research Database

In terms of timing, a profit warning should be issued at least three months before the release of full year audited financial statements and as early as possible. The issue should be after the issuer is satisfied that a reasonable degree of certainty exists that there will be a shortfall in earnings. Furthermore, the determination of a reasonable degree of certainty in terms of an earnings shortfall should be a judgmental decision which has to be taken by the issuers' directors. The determination may differ from issuer to issuer depending on the nature of business and the factors to which they are exposed.

The current rules refer to events and circumstances which may not be applicable to all profit warnings.

## 7.0 Conclusion

The following are the recommended amendments to the USE listing rules:

- i) The requirement for listed companies to issue a profit warning when the earnings for a financial year will decrease by at least 25% compared to earnings in the previous financial year.
- ii) A profit warning can be qualitative, but if the issuer wishes it can issue a quantitative profit warning.
- iii) The profit warning should be issued at least three months before the release of full year audited financial statements and as early as possible

after the issuer is satisfied that a reasonable degree of certainty exists that there will be a shortfall in earnings.

- iv) The current continuous disclosure rule regarding material events or circumstances should be maintained.

Amending the USE listing rules with the above recommendations would significantly reduce the asymmetry of information in the market and build investor confidence in Uganda's listed companies as well as the market as a whole. This in turn would reduce the perceived riskiness of market, attracting more investors and therefore reducing the cost for companies to raise capital on the USE.