

## **Analysts' Coverage and Corporate Managers Opportunistic Disclosure Behavior in Earnings Press Release**

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### **Abstract :**

This research aims to examine whether analysts' coverage could possibly serve as a monitoring mechanism that would help improve the credibility of narrative reporting namely, earnings press release, by reducing the presence of impression management practices. Furthermore, this research aims to examine whether investors can see through managers' strategic disclosure choices in earning press release and penalize firms for this opportunistic behavior. Impression management practices are to be captured using Huang et al.,(2014) measure of abnormal positive tone (ABTONE) from the residuals of a tone model that controls for firm quantitative fundamentals including financial performance, growth prospects, and firm operating risk and complexity. Consistent with the monitoring effect hypotheses, the results have shown that analysts' coverage has a significant negative impact on impression management as captured by the ABTONE measure. Besides, the results have shown that ABTONE has a significant positive impact on firms' quarterly stock prices.

## 1. Introduction

Earnings press releases as one major form of corporate qualitative or narrative disclosure outlets commonly referred to as “soft information”, are to a great extent designed to provide further analysis and discussion for the company’s results of operations and performance as well as its predicted future as supplementary information to those contained in the financial statements. And since it has been well recognized that financial statements may provide an incomplete picture of the company economic circumstances, the role of earnings press releases and other narratives became more valued in the business community.

Supporting this notion, Davis et al. (2012), argued that financial analysts as well as investors rely heavily on earnings press release as one major source of value relevant information and that the capital market responds to the information content of these narratives. Furthermore, Demers & Vega (2010) argued that in certain circumstances the content of earnings press release could even be incrementally informative over other numerical presentations in the financial statements. Consistently, Aerts & Cormier (2009) argued that press releases process richer information relative to corporate annual reports as well as being more-timely, and more expressive means of communicating firm performance compared to the less flexible annual reports

Even though earnings press releases are prominently an integral part of a firm's disclosure strategy given how easily accessible they are, either directly through companies' websites or otherwise through wire news services, it is perceived that managers can also use them to influence third party perceptions for their own benefit and that is basically driven by the fact that earnings press releases encompass high flexibility regarding their content and format in the absence of any regulatory requirements (Huang, et al.,2014). Moreover, earnings press releases as well as other narratives other than the notes to the financial statement are not subject to external audit and as a consequence can easily be manipulated by corporate managers.

Managers' discretionary disclosure strategies that are aimed at distorting users' perceptions through an earnings press release, as well as other narrative disclosure outlets, are commonly referred to as impression management practices (Guillamon-Saorin et al.,2017) Such impression management practices occur in different forms and the accounting literature (e.g. Schleicher, 2012; Kimbrough & Wang ,2014; Leung et al., 2015; Oliveira et al., 2016) has presented a variety of impression management methods used in corporate narrative reporting, to mention a few: (i) *Reading ease or syntactical manipulation* (e.g. obfuscating bad news by making narrative disclosures uneasily read ), (ii) *Rhetorical manipulation*(e.g. making linguistic

choices and using rhetorical devices, such as pronouns and the passive voice to persuade or impress readers and conceal negative performance) (iii) *Thematic manipulation* (e.g. the use of an overly optimistic or pessemestic disclosure tone rather than a nuterl one with the intent of creating a good image of the firm), (iv) *Performance comparisons* ( e.g. selectively disclosing benchmarks that display firm performances as being more superior compared the industry average) and (v) *Attribution of performance* (e.g attributing positive organizational outcomes to internal factors including the potentials of human resources, a company strategic plan, know-how, and negative organizational outcomes to external factors such as the general business climate, inflation, market prices, government policy).

This research attempts to extend prior literature addressing the main determinants of manager's strategic reporting strategies in narrative reporting by examining the association between *impression management practices* (i.e. thematic manipulation) and one major corporate characteristic that is conjectured to have an impact on manager's opportunistic behavior in the accounting literature and that is basically *analyst coverage* ( i.e. number of analysts actively tracking and publishing opinions on a company and its stock).

Even though a stream of research ( e.g: Degeorge et al., 2013; Liu, 2014; Allen et al., 2016; Hamrouni et al., 2017) has

come to address the association between analyst coverage and a variety of accounting choices, including discretionary accruals, managers' meeting/beating behavior and tax aggressiveness, Until recently the possibility that analyst coverage could influence impression management in narrative reporting has not been widely recognized in the accounting literature and still is an open question.

Beyond analysts' role in mitigating impression management, this research further attempts to examine whether the capital market identifies and penalizes firms disclosing information that is accompanied by impression management practices. Prior studies addressing the capital market reaction to impression management in narrative reporting are to a great limited to the context of highly developed countries that have an institutional setting that differs from most developing countries where strong investor protection regulatory environment and strong legal enforcement is less prevalent.

## **2. Literature review and hypothesis development:**

### **2.1. Impression management practices in narrative disclosure outlets and its major determinants**

while a wide range of prior research addressing the quality of corporate financial information has focused on the use of biased earnings figures (i.e. earnings management)

which represent a direct manipulation of the numbers disclosed in corporate financial reports, recently number of studies(e.g. Guillamon-Saorin et al.,2012; Cho, et al.,2012; Solomon et al.,2013; Zhang & Aerts,2015; Săndulescu & Albu, 2018) have come to address that firms also use more aggressive disclosure strategies commonly referred to as impression management practices that are aimed at influencing external users' impressions of an entity financial performance, basically by manipulating how corporate narrative documents are written and presented

With regard to major corporate settings that are presumed to have an influence on different impression management practices in narrative reporting, there have been mainly two streams of research. The first stream of research has focused on managerial strategic incentives for impression management. For instance, Tama-Sweet (2014) has found evidence that insider trading and more specifically, CEOs' equity sale shortly after earnings announcement is associated with thematic manipulation in earnings press release.

Furthermore, Huang et al. (2014) provided evidence that managers use their discretion over earnings press release content and format for strategic purposes related to meeting/beating benchmarks, seasoned equity offerings, and stock option grants. Moreover, Arslan-Ayaydin et al., (2016) examined whether

equity-based incentives could induce managers to participate in self-serving disclosure practices in earnings press releases and found that corporate managers' use of an abnormal positive tone in the narrative section of earnings press releases is driven by their equity-based incentives

The second stream of research though, focused on the detection and mitigation of impression management practices, by examining the association between different impression management practices and the monitoring role of corporate governance mechanisms. For instance, García Osma & Guillamón-Saorín (2011) demonstrated that “strong governance” limits impression management in annual results press release. They captured the effectiveness of a firms' governance using a composite score of seven different measures including board size, board composition, CEO independence, and board meetings. Consistently, Melloni et al (2016) have found evidence that weak corporate governance mechanisms are associated with the presence of impression management.

## **2.2. Analysts' coverage and corporate managers' disclosure behavior**

Two contradicting views are evident in the accounting literature regarding the impact of analysts' coverage and the information content of corporate disclosures. On the one hand,

analysts may deter misreporting and discipline managerial opportunistic accounting choices by serving as external monitors alongside traditional mechanisms of corporate governance. The basic premise is that there is growing evidence supporting the monitoring role of financial analysts. When a company is followed by more analysts, it is more likely that manipulation is brought to light by analysts' insightful analysis. Accordingly, managers of firms with high analyst coverage could be more concerned with the costs of misreporting.

Supporting the monitoring effect hypothesis, Yu (2008) and Knyazeva (2007) found that aggressive discretionary accruals are lower for firms followed by more analysts as compared to other firms with low analyst coverage, suggesting that analyst coverage ultimately constrain managerial misreporting behavior. Dyck et al. (2010) on the other hand have found evidence that analysts are more effective than both the Securities and Exchange Commission and auditors in the discovery of corporate fraud. Furthermore, Sun (2011) found that managers' income smoothing behavior is more informative to outside investors when firms are followed by more analysts.

Similarly, Sun & Liu (2011) found that corporate managers adopt more conservative financial disclosure behavior as the number of sell-side financial analysts following a firm increases. In an international setting, Degeorge et al., (2013) found that in

highly financially developed countries higher levels of analysts coverage results in lower earnings management. More recently, Black et al., (2018) found that managers become more aggressive in their non-GAAP reporting following an exogenous decline in analysts' coverage consistent with the notion that analysts discipline managers' non-GAAP disclosures.

On the other hand, analysts' following is basically accompanied by the release of earnings forecasts that would usually set a target for managers who eventually become exposed to excessive pressure trying to achieve this target. This is because missing earnings targets will be negatively and more rapidly incorporated into stock prices for firms with high analyst coverage, thereafter reducing managers' equity-based compensation and impairing their reputation and future career (He & Tian, 2013; Sun & Liu, 2016). As a consequence corporate managers could be more willing to engage in some deceptive reporting practices in order to meet a short-run earnings target set by sell-side financial analysts. This argument is referred to as the pressure effect hypothesis.

Supporting the pressure effect hypothesis, Cang (2014) found that analyst coverage stimulates earnings management through discretionary accruals where earnings management cannot be easily detected. Consistently, Sun & Liu, (2016) found evidence that when firms are followed by more analysts, real

earnings management becomes more evident with the intend of meeting or beating analysts' earnings benchmarks.

Finally, beyond corporate managers' motives to meet or beat analysts' forecasts, it is also presumed that analysts themselves are sometimes under pressure from a variety of sources, which could distort their incentives and undermines their governance role in disciplining managers' misreporting behavior. These pressures include the need to pursue investment banking business, the need to maintain good relationships with management for access to private information, and the need to avoid downgrades in stocks in which major clients have significant holdings (Yu, 2008).

### ***2.3. Capital market reaction to impression management in narrative reporting***

Since the ultimate goal of managers' strategic actions is to influence stock valuations, several empirical studies (e.g. Henry, 2008; Davis et al., 2012; Davis & Tama-Sweet, 2012; Huang et al., 2014; Arslan-Ayaydin et al., 2016; Guillamon-Saorin et al., 2017; ) documented the stock market reaction to manager communication practices in narrative reporting. Evidence provided by Huang et al.,(2014) suggests that investors are only temporarily misled by manager's strategic

disclosure choices through an earnings press release and that investors can penalize firms for managerial opportunism.

Supporting these findings, Guillamin-Saorin et al., (2017) have found evidence that investors are able to see through managers' intentions and discount non-GAAP information that is accompanied by high impression management. Arslan-Ayaydin et al., (2016) as well have found evidence that investors discount for tone inflation in the earnings press release for firms where the managerial utility maximization is strongly dependent on the value of the stock price.

However, these studies are to a great extent limited to highly developed capital markets that differ dramatically from most emerging capital markets that are viewed as having weak investor protection and poorer legal enforcement quality. These conditions may prompt more aggressive narrative reporting practices that even financial analysts can be misled and thereby investors may not be able to detect impression management and appropriately discount them (Guillamon-Saorin et al., 2017). Thereby, Egypt could provide an interesting institutional setting to examine the impact of impression management on the firm stock market valuation.

**Based on the above discussion, this research main hypothesis could be stated as follows:**

H<sub>01</sub>: Analyst coverage has no significant impact on impression management practices in earnings press releases.

H<sub>02</sub>: The presence of Impression management practices in an earnings press release has no significant impact on the firm stock prices.

H<sub>03</sub>: Analyst coverage has no significant indirect impact on firm stock prices.

### **3. Research Method**

#### **3.1. Sample description**

This research final sample comprises 42 publicly listed firms in the EGX 100 index for the period of 2015 Q1 up to 2020 Q1. Constituents of this index are only actively traded companies and are highly committed to various forms of voluntary disclosure including earnings press release. Furthermore, EGX100 avoids concentration on one industry and therefore has a good representation of various industries/sectors in the economy.

#### **3.2. Content analysis and tone measurement:**

This research employs thematic content analysis (i.e., linguistic tone analysis) using computer-aided techniques in order to capture disclosure tone or language sentiment of quarterly earnings press releases. In particular, this research

thematic analysis is intended to relay on textual analysis software **LIWC** (Linguistic Inquiry and Word Count)<sup>1</sup>, which is a dictionary-based program that analyses written samples of text on a word-by-word basis and calculates the number of words that match pre-defined word categories including positive and negative emotions. Recent studies adopting LIWC in the context of accounting research include Larcker & Zakolyukina (2016); Aerts & Yan (2017); Asay et al., (2018); Kang et al., (2018); and Ataullah, Vivian & xu (2018).

Using LIWC generic linguistics algorithm, the researcher attempts to estimate four measures of disclosure **TONE** namely, *TONE\_H*, *TONE\_LM*, *TONE\_EMOTION*, and *TONE\_NET EMOTION*. Where *TONE\_H* and *TONE\_LM*, correspond to the measures based on negative and positive word lists from Henry (2008) and the ones by Loughran & McDonald (2011) respectively<sup>2</sup>. While *TONE\_EMOTION* and *TONE\_NET EMOTION*, are driven based on LIWC embedded linguistic categories. All four of these measures are already popular choices in practice.

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<sup>1</sup> The researcher uses 2015 version of LIWC which is currently the latest version

<sup>2</sup> aThe researcher obtain the Henry word list from Fig. 1 of Henry (2008) and the Loughran and McDonald word list from the following: website: (<https://sraf.nd.edu/textual-analysis/resources/>)



Where:

TONE= The scores of the principal component analysis (PCA) of the four tone measures addressed in the earlier section

EARN= Earnings before extraordinary items scaled by lagged total assets

RET = Quarterly stock returns measured as  $((p_1 - p_0) + \text{Div}) / p_0$ <sup>3</sup>

SIZE = Logarithm of market value of equity at the end of each fiscal quarter

BTM = Book-to-Market ratio measured as book value of equity divided by market value of equity (i.e market capitalization)

STD\_RET = Standard deviation of quarterly stock returns over the last 4 quarters.

STD\_EARN= Standard deviation of EARN calculated over

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<sup>3</sup> P<sub>0</sub>= stock price at the beging of the financial quarter, p<sub>1</sub>= stock price at the end of the financial quarter, DIV= dividends per share

the four quarters preceding the end of fiscal quarter  $q$  of year  $t$ .

AGE = Log (1 + age from the first year the firm got listed in Egyptian stock exchange)

BUSSEG = Log (1+ number of business segments)

GEOSEG = Log (1+ number of geographic segments)

LOSS = A dummy variable set to 1 when EARN is negative, and is 0 otherwise

$\Delta$ EARN= Change in earnings before extraordinary item scaled by lagged total assets

This model decomposes tone into a non-discretionary (or “normal”) component, reflecting unbiased neutral description of firms’ fundamentals, and a discretionary (or “abnormal”) component that likely arises from corporate managers manipulative disclosure choices. More specifically, normal tone is the predicted value of equation (1). While abnormal tone is the residual term of equation (1) or in other words the error term. ABTONE is therefore designed to be unrelated to firm fundamentals and business environment.





SP=	Quarterly stock prices
ABTONE =	The signed residual of eq (1)
SIZE =	Firm size measured as logarithm of market value of equity at the end of each fiscal quarter
BTM =	book-to-market ratio measured as book value of equity divided by market value of equity (i.e market capitalization)
ROA =	the firm's return on assets reported for that quarter
LEVERAGE=	Total liabilities deflated by total equity
STD_RET =	standard deviation of quarterly stock returns over the last 4 quarters

### 3.5. Multivariate Analysis:

Table (1) presents the results of estimating equation (1). The dependent variable in this equation is the tone in the quarterly earnings press release. The overall model is significant ( $F = 18.57, p < 0.01$ ). As shown in table (1) disclosure tone appears to be more positive when the firm is (a) profitable, (b) larger, (c) older (d) has less volatile stock returns, (e) has more business segments, and (f) more geographic segments. These results are consistent with those reported by Loughran &

McDonald, 2011, Huang et al. (2014), and Davis et al., (2014). The residual from this model is the measure of abnormal disclosure tone, used in the subsequent regressions.

**Table (1): Regression estimates of equation (1)**

Variables	Coefficient	Std.Err	p-value
<i>Intercept</i>	-1.774763	0.4989517	0.000
<i>EARN</i>	0.7649922	1.874841	0.683
<i>RET</i>	0.0526054	0.0924795	0.570
<i>SIZE</i>	0.2196106	0.0631163	0.001***
<i>BTM</i>	-0.1006434	0.0424198	0.018**
<i>STD_RET</i>	-0.2008342	0.1142802	0.079*
<i>STD_EARN</i>	0.5626012	1.892691	0.766
<i>AGE</i>	0.0013646	0.1383416	0.992
<i>BUSSEG</i>	0.4724172	0.2423986	0.052**
<i>GEOSEG</i>	0.2138583	0.1219992	0.080*
<i>LOSS</i>	-0.2416411	0.1210133	0.046**
$\Delta EARN$	-0.3223844	0.9214395	0.727
<i>N</i>	633		
<i>Adjusted R<sup>2</sup></i>	0.1119		
<i>p-value (F-statistic)</i>	0.000		

\*, \*\*, \*\*\* Indicates  $p$ , 0.10,  $p$ , 0.05 and  $p$ , 0.01, respectively.

Table (2) presents the results of estimating equation (2)<sup>4</sup>. Consistent with the previously stated correlation results, the regression analysis shows a significant negative impact of

<sup>4</sup> Reported results include firm fixed effects in regressions, with robust standard clustered errors.

analysts' coverage on ABTONE, thereby suggesting that when more analysts are following a firm, corporate managers are less likely to engage in thematic manipulation in quarterly earnings press release. This result support prior studies (e.g. Degeorge et al., 2013; Black et al., 2018; Ayers et al., 2019) argument that beyond traditional governance mechanisms, financial analysts play an important role in shaping managers reporting behavior and may deter misreporting and discipline managerial accounting choices by serving as external monitors.

Regarding governance control variables, the results show that CEOs dual role and CEO ownership are associated with less ABTONE as demonstrated by the negative and statistically significant coefficient of the variables (DUALITY) and (CEO\_OWN) (-0.3941 and 0.043, at 5% and 1% significant levels respectively), which implies that the alignment of interests, unity of command and more powerful CEOs are more likely to fulfill their monitoring role and enhance the credibility of earnings press release.

This result is inconsistent with prior work by Mather and Ramsay (2007) who have shown that the concentration of the roles of CEO and chairman of the board in the same person is associated with increased impression management practices as captured by selectivity in graph disclosure. They have argued that boards are expected to be more independent and efficient

when the chairman of the board is not an executive director. Moreover, consistent with (Melloni et al., 2016) no statistically significant relationship is shown between the fraction of independent board members and ABTONE.

With reference to other control variables, there is a significant negative impact of ROA on ABTONE, thereby indicating that less profitable firms are more inclined to disclose information that is intended to misinform users of the financial information. This is consistent with Leung et al., (2015) findings who have shown that firms with poor current performance measured by either accounting or market-based performance firms are more likely to engage in the concealment of voluntary narrative information in annual reports.

The firm size on the other hand, as well as LEVERAGE, has an insignificant impact on ABTONE which implies that a firms related risk and operating complexity does not necessarily affect the biased disclosure tone of earnings announcement. Finally, the results show that certain strategic setting such as seasoned equity offering (SEO) and likewise the industry group has no significant impact on corporate managers' strategic disclosure behavior in earnings press release.

**Table (2) regression estimates of equation (2):**

<b>Variables</b>	<b>Coefficient</b>	<b>Std.Err</b>	<b>p-value</b>
<i>INTERCEPT</i>	-0.2263368	0.9627122	0.815
<i>ANALYSTS</i>	-0.123005	0.1222610	0.000***
<i>SEO</i>	0.0382493	0.0671307	0.572
<i>CEO_OWN</i>	-0.0434099	0.0036486	0.000***
<i>DUALITY</i>	-0.3941223	0.1874231	0.042**
<i>INDEPENDENT</i>	-0.1766222	0.3243406	0.589
<i>SIZE</i>	0.2584755	0.1642824	0.123
<i>ROA</i>	-0.124964	0.0741762	0.100*
<i>LEVERAGE</i>	-0.0461375	0.0312175	0.147
<i>INDUSTRY</i>	0.1429095	0.9281099	0.878
<i>N</i>	632		
<i>Adjusted R<sup>2</sup></i>	0.6228		
<i>p-value (F-statistic)</i>	0.000		

\*, \*\*, \*\*\* Indicates  $p$ , 0.10,  $p$ , 0.05 and  $p$ , 0.01, respectively.

Table (3) presents the results of estimating equation (3). Again, the researcher used a cluster-robust regression model with firm-fixed effects to minimize possible cross-sectional or inter-temporal correlations. Inconsistent with H<sub>2</sub>, The positive and significant coefficient of ABTONE indicates that the use of biased disclosure tone in earnings press release leads to an optimistic capital market response. One possible explanation would be that capital market participants might not accurately recognize the opportunistic and misleading behavior in the form of a positive disclosure tone through earnings press release and that corporate managers successfully impress investors using an

abnormal tone. Furthermore, the results have shown that each of the firms' related characteristics including SIZE, BTM, LEVERAGE, and STD\_RET significantly affect the capital market response.

**Table (3) Regression estimates of equation (3)**

Variables	Coefficient	Std.Err	p-value
<i>INTERCEPT</i>	-46.08523	5.763406	0.000
<i>ABTONE</i>	2.210572	0.5417982	0.000***
<i>SIZE</i>	8.73756	0.8955919	0.000***
<i>BTM</i>	-2.033626	0.8093501	0.012**
<i>ROA</i>	0.7243715	1.053919	0.492
<i>LEVERAGE</i>	1.903668	0.3383276	0.000***
<i>STD_RET</i>	-3.282344	1.108861	0.003***
<i>N</i>	632		
<i>Adjusted R<sup>2</sup></i>	0.926		
<i>p-value (F-statistic)</i>	0.000		

**\*\***, **\*\*\*** Indicates *p*, 0.05 and *p*, 0.01, respectively.

### Summary and conclusion:

This research aims to contribute to an emerging stream of literature that has shown a growing interest in textual content analysis of corporate qualitative disclosures. Furthermore, this research aims to extend prior literature addressing the main determinants as well as the market reaction to the managers' strategic reporting choices in narrative reporting.

Using firm fixed effect regression analyses the results have shown that analysts' coverage significantly negatively influence the presence of thematic manipulation in earnings press releases. This result is consistent with the monitoring effect hypotheses which implies that analysts deter misreporting and discipline managerial opportunistic accounting choices either by serving as external monitors alongside traditional mechanisms of corporate governance or otherwise by means of regular tracing of a firm financial statements. More specifically proponents of the monitoring effect hypotheses posit that when a company is followed by more analysts it is more likely that manipulation would be detected and accordingly managers fear of losing coverage limits their opportunistic behavior.

Furthermore, inconsistent with Guillamin-Saroin et al., (2017) and Arslan-Ayaydin et al.,(2016) the results have shown that the presence of thematic manipulation in earnings press release has a significant positive impact on the firms stock prices which indicate that capital market participants might not be able to see through managers strategic reporting intentions in earnings press releases and fail in penalizing firms for managerial opportunism leading to a significant security mispricing.

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