Are Companies That Stick to Script on Earnings Calls Hiding Bad News? (January 15, 2016)

Accounting & Compliance Alert--Complete Edition (WG&L)

Friday, January 15, 2016

Volume 10, No. 10

ISSN 1935-9721

Today's News

Governance News

Are Companies That Stick to Script on Earnings Calls Hiding Bad News?

Topic(s): Disclosure, Financial Management, Financial Reporting, Risk, Corporate Governance, Ethics

Summary: *A study found that analysts tend to revise future earnings following quarterly earnings calls in which management responded to questions with scripted answers. Analysts believe that companies may be hiding bad news when they do not deviate from their scripts.*

Companies have been managing bad news by providing scripted answers during quarterly earnings conference calls with analysts.

Now an academic study is questioning whether it is a smart move for a CEO or CFO to rigidly stick to a script, given that securities analysts and investors can quickly detect a company that is avoiding releasing bad news.

"Analysts revise downward their forecasts of future earnings following calls with scripted Q&A," writes Joshua Lee, an assistant professor of accounting at Florida State University. "Investors' reaction to managers' lack of spontaneity is consistent with negative future unexpected accounting performance in the next two quarters."

"These results suggest that the negative market reaction to scripting is likely due to the signal it provides about future performance and not due to the greater levels of information provided in the call about the future performance," the study noted. "These results are of potential interest to market participants who rely on information provided during earnings conference calls."

The study is in the January/February 2016 issue of *The Accounting Review* published by the American Accounting Association.

To provide evidence that scripted answers are a warning signal to investors, Lee sifted through 40,820 transcripts of quarterly earnings conference calls for 2,863 public companies from 2002 to 2011.

Lee found that shares of companies which relied most heavily on scripting had a two-day market-adjusted return significantly below the sample mean on the day of and the day following conference calls.

The mean two-day, market-adjusted return for the sample was a gain of 0.1 percent. But heavily scripted companies lost 0.2 percent. In contrast, shares of companies that used only minimal scripting or did not use scripting at all rose 0.3 percentage points above the mean.

The study found that the market responses were not misguided.

Over the two quarters, mean unexpected earnings of the firms that scripted the most were 12.5 percent lower than mean unexpected-earnings of the full sample, suggesting that the heavy scripters had more bad news to hide at the time of the conference call.

Lee also said there may be valid explanations for a CEO's reluctance to ad lib his answers to analysts and shareholders.

"A CEO or CFO who is not especially fluent may simply prefer to have answers laid out in advance, so one can't be sure that some kind of concealment is going on without knowing the chief's normal modus operandi," Lee said. "A better bet is to listen for shifts between spontaneous answers and what sound like scripted ones, shifts suggesting a sensitive issue."