

ACCOUNTING & AUDIT

Report: Is Extreme Language in Earnings Calls a Benefit for Investors and Managers?

The effect of this strong language is substantial, according to the research by Khrystyna Bochkay of the University of Miami, Jeffrey Hales of the University of Texas at Austin, and Sudheer Chava of Georgia Institute of Technology.



"It's been five full years since I called BS and declared war...against [this] stupid, broken, arrogant industry...We have great financial results...very strong free cash flow...As you can tell, we're incredibly confident in our future."

What to make of extreme language like this from the transcript of a top company executive in an earnings conference call? Hype? Bluster? Refreshing dose of reality?

A new study will likely find agreement among many financial market observers when it acknowledges that "market participants might be largely skeptical of extreme language, particularly when optimistic, because managers have wide latitude in how they describe performance of their firms...and if things later turn south, managers may claim in court that their prior statements were mere 'puffery.' "

This hazard notwithstanding, the new paper in *The Accounting Review*, a peer-reviewed journal of the **American Accounting Association**, goes on to find that "investors appear to largely treat extreme language as an informative signal, as it stimulates significant trading activity and generates strong price reactions."

And, wonderful to relate, this receptiveness largely pays off for investors. As the new study concludes, extreme language is not principally a reflection of management style or a way to spread hype or mislead investors. Rather, it "is positively associated with future earnings and sales. In contrast, moderate language exhibits no or weak association with future performance...[M]anagers appear, on average, to use extreme language to convey information about future operating performance."

The effect of this strong language is substantial, according to the research by Khrystyna Bochkay of the University of Miami, Jeffrey Hales of the University of Texas at Austin, and Sudheer Chava of Georgia Institute of Technology. Enlisting individuals through a crowd-sourcing Internet marketplace to judge the linguistic extremity of words uttered in earnings conference calls, the researchers find that a mere 1.33% increase in extreme words conveying optimism results in about a 6% increase in trading volume in a stock and a 0.63% boost in price over three days. As the study notes, these represent increases above and beyond those attributable not only to actual financial results but also to the linguistic tone of executives' comments, as measured by proportions of positive to negative words.

Thus does the paper take a sizable step beyond a large body of research on the effects of linguistic tone in various kinds of financial reporting – prior studies that focused on the relative preponderance of positive and negative words without considering how strongly expressive they are.

The new research also finds that the extra boost in share prices that occurs when extreme language accompanies positive earnings surprises is not just a temporary blip; on the contrary, three-day increases are largely sustained over time. Analyzing cumulative buy-and-hold investor returns in the 60 trading days following quarterly earnings conference calls, the professors observe "no significant drifts or reversals in prices, suggesting that investors price the information in extreme language correctly." Extending their analysis further to the relationship of linguistic extremity to one-year-ahead earnings and sales, they report extreme language to be positively associated with both.

What about conference calls when earnings fall short of forecasts? Strong expressions of optimism can to some extent be effective then too, according to the study, making impressions on investors and helping limit shareholder losses.

In addition, to its impact on investors, linguistic extremity significantly affects professional stock analysts as well. The professors find that it increases both the magnitude of forecast revisions and the proportion of analysts undertaking revisions. In the words of the paper, “analysts react to extreme language in earnings calls more strongly than they do to more moderate language... [A]nalysts, similar to investors, attend to the type of language used in conference calls and, at least on average, find the nuances of language to be informative.”

The study’s findings derive from a massive effort at linguistic analysis that involved categorizing words in transcripts of 60,940 earnings conference calls, including both the introductory remarks and the Q&A sections. Individuals from an Internet crowd-sourcing marketplace that is frequently used in social-science research were tasked with ranking by linguistic extremity nouns, verbs, adjectives, and short phrases. The result: a dictionary of 23,355 words and phrases, each scored on a scale of -5 (strongly negative) to +5 (strongly positive). Examples are as follows:

- +5: terrific, excellence, incredible, amazing
- +3: solid, effective, accomplishment, strengthen
- +1: competitive, encourage, steady, transparency
- -1: limitation, heavy, undue, step back
- -3: difficult, volatile, underperform, unfavorable
- -5: terrible, default, devastate, worst

With ratings in hand, the researchers constructed ways to measure the proportion of linguistic extremity in transcripts, defining positive extreme words as those scored at +4 and +5 and negative extreme words as those at -4 and -5. Words rated at 1, 2, and 3 were classified as moderate – positive or negative, as the case might be. They then set about analyzing the relationship of ratings to short-term stock-trading volumes and price movements as well as to longer-term measures of stock returns, company financial performance, and analyst activity.

The professors see their findings as potentially valuable for investors and managers alike. Comments Prof. Hales, “While investors might be naturally suspicious of strong language from corporate managers, particularly when it is of the optimistic variety, our study cautions against rejecting it out of hand, as more often than not it reflects managerial conviction. As for CEOs, CFOs or other corporate managers involved in earnings conference calls, they might want to resist pressures from their legal departments to dampen their language when circumstances seem to warrant speaking out strongly. Indeed, our results suggest that many executives, to their credit, are

voicing their convictions in earnings calls, and this appears to help with price discovery.”

The new study, “Hyperbole or Reality? Investor Response to Extreme Language in Earnings Conference Calls,” is in the March issue of ***The Accounting Review***, a peer-reviewed journal published six times yearly by the **American Accounting Association**, a worldwide organization devoted to excellence in accounting education, research, and practice. Other journals published by the AAA and its specialty sections include *Auditing: A Journal of Practice and Theory*, *Accounting Horizons*, *Issues in Accounting Education*, *Behavioral Research in Accounting*, *Journal of Management Accounting Research*, *Journal of Information Systems*, *Journal of Financial Reporting*, *The Journal of the American Taxation Association*, and *Journal of Forensic Accounting Research*.