IÉSEG SCHOOL OF MANAGEMENT
EMPOWERING CHANGEMAKERS FOR A BETTER SOCIETY

LEM
UMR - CNRS 9221
LILLE ÉCONOMIE MANAGEMENT

Finance & Audit Control Research Seminar

"Peer-based Performance Benchmarking and Tone Management"

Pratik Goel – IÉSEG School of Management

Thursday, December 13th, 2018 – 15:00 – 16:30

In this study, we investigate the effects of *peer-based performance benchmarking* (comparison of own performance against performance of peer firms) on the firms' narrative disclosure strategy pertaining to *tone management* (use of abnormal positive or negative tone as a strategic tool to influence market perceptions). This is the first study that examines the narrative disclosure strategy of the firm through the lens of the behavioral theory of the firm (BTOF) introduced by Cyert and March (1963) in their seminal work. The application of the BTOF to the narrative disclosure literature is relevant and interesting because (i) according to the former, performance that exceeds/falls below the peer-based benchmark is *perceived* as success/failure, which could then possibly influence the disclosure strategy; and (ii) numerous studies have highlighted the role and importance of narrative disclosures as a means to bridge the gap between financial statement information and the underlying economic/business reality of the firm.

Using the earnings-related narrative disclosures in the 10-K filings of US firms over 1993-2013, comprising of 23,530 firm-year observations, we show that the narrative disclosures of firms with performance that falls below the peer-based performance benchmark exhibit greater downward tone management, that is, they are, on average, overly pessimistic. In addition to this *dichotomous* effect, we observe a *continuous* effect in the sense that the farther performance falls below the benchmark, the greater the observed downward tone management (or over-pessimism). Interestingly, we observe that the greater the downward tone management, the higher the future earnings of the firm. Thus, this downward tone management driven by peer-based performance benchmarking is suggestive of strategic managerial behavior to influence market perceptions (Huang et al., TAR 2014). Specifically, we hypothesize that this tone management is employed by managers as a tool for *expectations management*, via lowballing. In contrast to firms with performance falling below the peer-based benchmark, we find that the farther performance *exceeds* the benchmark, firms' narrative disclosures exhibit greater upward tone management (or over-optimism). Furthermore, this upward tone management does not explain future earnings, which, according to Huang et al. (TAR 2014), is suggestive of *impression management*.

Getting back to our earlier hypothesis about expectations management, we show that the greater downward tone management is further associated with a greater downward revision in financial analysts' forecast of future earnings. We also observe that the greater performance shortfall and consequent downward tone management translates into an even greater downward revision in the forecasts. In addition, we are currently testing whether the firms with performance falling below the peer-based benchmark in the current period eventually manage to meet/beat financial analysts' earnings forecast in the subsequent period. As it is still work in progress, we do appreciate your constructive comments and feedback on the day of the presentation.

Co-authors: *Pratik GOEL, Ankit JAIN (UQ Business School) and Oveis MADADIAN*

- **Paris: Visio Room PR13,** Promenade building
- **Lille: Room B254,** 3 rue de la Digue