

Earnings Management and Tone Management: Evidence from the UK

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Abstract : This study investigates, whether earnings management in the audited financial statements is associated with tone management in the narrative sections of the annual report in the UK. Earnings management and narrative disclosure are communication strategies used from managers to communicate with investors or other users. Because earnings management and narrative disclosure stem from managers, they can exploit this by doing manipulation in their earnings, and simultaneously disclosing qualitative text (narrative information) in their reports as a tone of words, which will affect users' perception, and hence users will be misinformed. The association between earnings and tone management can be explained by the self-serving, through cognitive reference points, theory. The sample period lasts from 2010 to 2015, and the sample comprises all non-financial firms that consider under FTSE 350 in any year during the sample period. A list of words from previous research is used to measure the tone in the narrative sections of the annual report. Because this study focuses on the managerial strategic choice and the subjective issues that come from management, it uses the abnormal tone to capture the managerial discretion on tone, and a number of different discretionary accruals proxies to measure earnings management, where accruals management is considered as a manipulation tool from managers to change the users' perception. This research is motivated to fulfil the literature gap by examining the association between earnings and tone management. Moreover, if firms that apply earnings management use tone management to mislead investors, it is beneficial for investors, policy makers, standard setters, or other users to know whether there is an association between earnings management and tone management. Clearly, we believe that this study is fundamental in the accounting context, where it evaluates the communication strategies that are used in firms' financial reports. Consistent with prior research, it is expected that tone management is positively associated with earnings management. This means that firms that use earnings management have incentives to manipulate in their narrative disclosure through tone of words, to reflect a good perception for users, which will conceal the earnings management techniques used in their reporting.

Keywords : earnings management, FTSE 350, narrative disclosure, tone management

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