Narrative Conservatism

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Outline

Research Question and Contribution

- **Research Question**
  - Whether narrative disclosure is conservative, i.e., whether narratives respond to bad news in a more complete, news-consistent and timely manner than good news?

- **Contribution**
  - Filling the missing piece in conservatism literature by documenting the existence of narrative conservatism
  - Providing novel evidence to the debate regarding whether managers withhold bad news.
  - Relating to the broader literature on the informativeness of SEC filings.
  - Adding to the literature on distinction and interaction between recognition and disclosure.

Theoretical Framework: Recognition and Disclosure

- **Definition (Schipper, 2007)**
  - Recognition: depictions in numbers with captions on the face of the financial statements
  - Disclosure: display in the notes and supporting schedules that accompany financial statements

- **Reporting Requirement (FASB, 1984)**
  - Recognition: an economic event can be recognized if it satisfies all of the following criteria
    - Definition criterion
    - Measurability criterion
    - Relevance criterion
    - Reliability criterion
  - Disclosure: can be deployed to disclose information that fails to meet certain recognition criteria

- **Role of Narratives**
  - Disclose information that cannot be recognized
  - Explain recognized line items

Theoretical Framework: Conservatism

- **Definition**
    - Conditional and unconditional conservatism
    - Narrative conservatism: narratives responding to bad news in a more complete, news-consistent and timely manner than good news
- **Why do firms disclose or withhold bad news?**
    - Disclose: lower financing costs resulting from reduced information asymmetry, litigation risk due to the failure to disclose bad news in a timely manner and managers' personal incentive to manipulate firm performance downwards prior to stock option grant
    - Withhold: managers' future career concern and performance-based compensation
- **Hypotheses**
    - **H1:** The total number of words in narrative disclosure is greater in response to bad news than good news.
    - **H2**: The marginal change of tone in narrative disclosure is greater in response to bad news than good news.
    - **H3**: The reporting time lag of narrative disclosure is shorter in response to bad news than good news.

Theoretical Framework: Conservatism Cont.

- **Is conservatism useful?**
  - Valuation role: provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity (FASB, 2018, OB2)
  - Stewardship role: how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's economic resources (FASB, 2018, OB4)

- **Is narrative conservatism useful?**
  - We posit that narrative conservatism enhances contract efficiency and serves the stewardship role of accounting
  - Testable hypotheses to be developed

Research Design: Model

- **Narrative Disclosure Corpora and News Proxy**
  - Narrative Disclosure Corpora are 10-Q and 8-K filings because they (a) are more credible, (b) have higher reporting threshold and (c) are more timely than other corporate communication channels.
  - Heterogeneity between 10-Q and 8-K: (a) 10-K is more diversified in content (b) 8-K is more timely.
  - News proxy is stock returns, assuming market efficiency.

- **Model Specification**
  - Form 10-Q
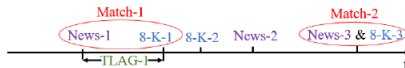
  $$TEX_{i,t} = \beta_0 + \beta_1 QRET_{i,t} + \beta_2 NEG_{i,t} + \beta_3 QRET_{i,t} \times NEG_{i,t} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \quad (1)$$

  - Form 8-K

  $$TEX_{i,t} = \beta_0 + \beta_1 \Delta DRET_{i,t-tlag} + \beta_2 BN_{i,t-tlag} + \beta_3 \Delta DRET_{i,t-tlag} \times BN_{i,t-tlag} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \quad (3)$$

Figure 1: 8-K Merging Process

Research Design: Data

- Historical financial and segment data from Compustat, stock returns from the Center for Research in Security Prices (CRSP) and analyst earnings forecasts data from I/B/E/S.

Table 1. Sample Selection Process

10-Q

Numer of observations:	
Retrieved from EDGAR	575,579
After merging with COMP and CRSP data	190,341
After merging with I\B\E\S and segment data	110,114
After dropping obs. with missing values in key variables and screening	**91,606**

8-K

Numer of observations:	
Retrieved from EDGAR	1,489,626
After merging and matching with COMP and CRSP data	390,698
After dropping obs. with missing values in key variables and screening	**244,401**
After filtering obs. with TLAG smaller or equal to four (five) days after (before) the 8-K reform (Restricted 8-K sample)	**62,301**

Results: Summary Statistics

Table 2. Panel A: Summary Statistics 10-Q

	count	mean	std	min	25%	50%	75%	max
Textual Vars.								
NW	91606	8.946	0.764	7.044	8.424	9.010	9.477	13.490
nw	91606	10215	9673	1145	4552	8180	13058	722159
TONE	91606	-8.457	6.885	-64.543	-12.434	-7.472	-3.641	22.287
TLAG	91606	39	6	0	36	40	44	52
ABTONE	91606	0.000	6.577	-57.658	-3.747	0.871	4.563	31.522
Financial Vars.								
QRET	91606	0.018	0.253	-1.579	-0.113	0.007	0.130	4.849
NEG	91606	0.483	0.500	0	0	0	1	1
SIZE	91606	6.447	1.776	2.002	5.175	6.317	7.563	11.206
MTB	91606	3.516	4.009	0.288	1.485	2.343	3.902	30.901
LEV	91606	0.192	0.182	0.000	0.011	0.162	0.315	0.724
AF	91606	0.043	0.066	-0.262	0.023	0.049	0.073	0.227
AFE	91606	-0.021	0.067	-0.445	-0.018	-0.002	0.002	0.078
BUSSEG	91606	0.859	0.447	0.693	0.693	0.693	0.693	2.773
GEOSEG	91606	0.898	0.532	0.693	0.693	0.693	0.693	3.045
AGE	91606	8.312	1.033	5.811	7.635	8.420	9.089	10.288
EARN	91606	0.005	0.042	-0.201	0.001	0.012	0.023	0.084
ΔEARN	91606	0.002	0.031	-0.126	-0.006	0.001	0.008	0.150
STD_EARN	91606	0.020	0.030	0.001	0.005	0.009	0.021	0.188
STD_QRET	91606	0.089	0.070	0.007	0.040	0.070	0.115	0.379
LOSS	91606	0.242	0.429	0	0	0	0	1

Results: Summary Statistics Cont.

Table 2. Panel B: Summary Statistics 8-K

	count	mean	std	min	25%	50%	75%	max
Textual Vars.								
NW	244401	6.086	0.899	4.898	5.561	5.849	6.351	13.580
nw	244401	1258	6279	133	259	346	572	789969
TONE	244401	-0.451	7.323	-97.851	-2.865	0.000	3.677	50.898
TLAG	244401	23	25	0	4	14	33	142
N8K	244401	1	0	1	1	1	1	5
NITEM	244401	2	1	1	2	2	2	16
Financial Vars.								
DRET	244401	0.003	0.094	-0.952	-0.038	-0.003	0.041	6.606
ΔDRET	244401	-0.015	0.174	-9.062	-0.114	-0.047	0.096	6.597
BN	244401	0.538	0.499	0	0	1	1	1
SIZE	244401	6.395	1.975	2.174	5.004	6.337	7.712	11.410
MTB	244401	3.798	4.830	0.161	1.394	2.339	4.124	33.727
LEV	244401	0.205	0.193	0.000	0.012	0.172	0.335	0.749

Results: 10-Q Main Results

Table 3. Panel A: Main Results 10-Q

Dep. Vars.	(1) NW	(2) NW	(3) TONE	(4) TONE	(5) TLAG	(6) TLAG
QRET	0.241***	0.041***	-2.909***	0.266**	0.932***	-0.269**
	(14.68)	(3.23)	(-19.15)	(2.10)	(7.13)	(-2.35)
NEG	0.003	0.006	0.123*	-0.101**	-0.156***	0.027
	(0.50)	(1.33)	(1.96)	(-2.26)	(-2.89)	(0.73)
Sign Prediction	-	-	+	+	+	+
QRET×NEG	-0.530***	-0.138***	8.838***	1.797***	-5.602***	-0.694***
	(-18.28)	(-5.70)	(32.99)	(6.29)	(-24.31)	(-3.80)
SIZE	0.117***	0.017*	-0.404***	0.790***	-1.167***	-0.263**
	(80.34)	(1.94)	(-29.91)	(9.63)	(-100.38)	(-4.15)
MTB	-0.002**	-0.005***	0.017***	0.068***	0.077***	-0.023**
	(-2.43)	(-5.01)	(2.97)	(4.36)	(15.39)	(-2.22)
LEV	0.052***	0.324***	2.809***	-1.465***	1.495***	0.947***
	(3.84)	(9.28)	(22.62)	(-3.48)	(14.00)	(2.68)
Constant	8.137***	7.986***	-5.771***	-19.839***	45.609***	45.619***
	(749.57)	(146.16)	(-57.52)	(-32.77)	(528.37)	(83.95)
Observations	91,606	91,606	91,606	91,606	91,606	91,606
Adjusted R-squared	0.070	0.649	0.023	0.559	0.122	0.614
Year-quarter FE	NO	YES	NO	YES	NO	YES
Firm FE	NO	YES	NO	YES	NO	YES
Industry clustered SE	NO	YES	NO	YES	NO	YES

$$TEX_{i,t} = \beta_0 + \beta_1 QRET_{i,t} + \beta_2 NEG_{i,t} + \beta_3 QRET_{i,t} \times NEG_{i,t} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \qquad (1)$$

Results: 10-Q Additional Results

Table 3. Panel B: ABTONE 10-Q

Dep. Vars.	(1) ABTONE	(2) ABTONE	(3) TONE	(4) TONE
QRET	-1.296***	0.217*	-1.268***	0.245**
	(-8.10)	(1.76)	(-7.93)	(1.99)
NEG	0.116*	-0.105**	0.116*	-0.105**
	(1.91)	(-2.36)	(1.91)	(-2.36)
Sign Prediction	+	+	+	+
QRET×NEG	3.270***	0.656**	3.270***	0.656**
	(11.70)	(2.43)	(11.70)	(2.43)
SIZE	-0.034**	1.174***	-0.793***	0.415***
	(-2.25)	(14.70)	(-53.21)	(5.20)
MTB	-0.008	-0.020	0.070***	0.058***
	(-1.43)	(-1.30)	(11.89)	(3.85)
LEV	2.669***	-0.944**	2.669***	-0.944**
	(21.53)	(-2.11)	(21.53)	(-2.11)
EARN	1.553*	2.878	8.180***	9.505***
	(1.87)	(1.15)	(9.85)	(3.80)
STD_QRET	1.596***	4.358***	-4.162***	-1.400***
	(4.25)	(13.92)	(-11.08)	(-4.47)
STD_EARN	2.779***	13.467***	-16.281***	-5.593***
	(3.30)	(10.76)	(-19.33)	(-4.47)
AGE	-0.035	-0.420**	0.313***	-0.072
	(-1.49)	(-2.03)	(13.31)	(-0.35)
BUSSEG	-0.076	-0.033	0.412***	0.455**
	(-1.10)	(-0.15)	(5.93)	(2.09)
GEOSEG	0.074	1.205***	-0.958***	0.173
	(1.26)	(5.71)	(-16.34)	(0.82)
LOSS	0.043	1.737***	-3.112***	-1.419***
	(0.59)	(18.21)	(-42.55)	(-14.88)
ΔEARN	-1.292*	4.707***	-11.741***	-5.742***
	(-1.69)	(4.74)	(-15.32)	(-5.78)
AFE	0.474	-1.453***	5.964***	4.037***
	(1.31)	(-2.68)	(16.53)	(7.44)
AF	-1.473***	2.042**	-6.272***	-2.758***
	(-3.74)	(2.16)	(-15.95)	(-2.91)
Constant	0.107	-13.500***	-4.162***	-17.769***
	(0.51)	(-8.19)	(-19.89)	(-10.78)
Observations	91,606	91,606	91,606	91,606
Adjusted R-squared	0.006	0.528	0.093	0.569
Year-quarter FE	NO	YES	NO	YES
Firm FE	NO	YES	NO	YES
Industry clustered SE	NO	YES	NO	YES

$$ABTONE_{i,t} = \beta_0 + \beta_1 QRET_{i,t} + \beta_2 NEG_{i,t} + \beta_3 QRET_{i,t} \times NEG_{i,t} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \quad (4)$$

$$TONE_{i,t} = \beta_0 + \beta_1 QRET_{i,t} + \beta_2 NEG_{i,t} + \beta_3 QRET_{i,t} \times NEG_{i,t} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \quad (5)$$

Results: 8-K Main Results

Table 4. Panel A: Main Results 8-K

Dep. Vars.	(1) NW	(2) NW	(3) TONE	(4) TONE	(5) TLAG	(6) TLAG
ΔDRET	0.589***	0.074***	-3.616***	-0.883***	-15.164***	-17.949***
	(21.89)	(2.68)	(-16.47)	(-2.95)	(-20.25)	(-10.89)
BN	0.031***	0.013***	-0.156***	-0.066	0.463***	0.368**
	(5.64)	(3.17)	(-3.43)	(-1.49)	(2.98)	(2.11)
Sign Prediction	-	-	+	+	+	+
ΔDRET×BN	-1.055***	-0.102**	6.758***	1.878***	21.840***	27.702***
	(-29.54)	(-2.52)	(23.19)	(3.33)	(21.97)	(12.05)
SIZE	-0.007***	-0.012**	0.209***	0.159***	-1.392***	-0.697***
	(-6.77)	(-2.19)	(24.73)	(3.86)	(-48.27)	(-6.34)
MTB	0.006***	0.003***	0.002	-0.005	0.110***	0.027
	(15.13)	(3.44)	(0.71)	(-1.06)	(10.32)	(1.35)
LEV	0.373***	0.036	-1.797***	-0.726***	-4.005***	-3.697***
	(39.22)	(1.45)	(-23.16)	(-3.49)	(-15.13)	(-6.15)
Constant	5.947***	4.583***	-0.903***	-15.308***	33.099***	38.952***
	(692.25)	(39.39)	(-12.87)	(-21.54)	(138.42)	(14.59)
Observations	244,401	244,401	244,401	244,401	244,401	244,401
Adjusted R-squared	0.012	0.420	0.009	0.151	0.013	0.139
Year-month FE	NO	YES	NO	YES	NO	YES
Firm FE	NO	YES	NO	YES	NO	YES
Industry clustered SE	NO	YES	NO	YES	NO	YES

$$TEX_{i,t} = \beta_0 + \beta_1 \Delta DRET_{i,t-tlag} + \beta_2 BN_{i,t-tlag} + \beta_3 \Delta DRET_{i,t-tlag} \times BN_{i,t-tlag} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \quad (3)$$

Results: 8-K Additional Results

Table 4. Panel B: NITEM, N8K and TLAG 8-K

Dep. Vars.	(1) NITEM	(2) N8K_OL	(3) TLAG_OL
ΔDRET	0.193***	0.835***	-1.121***
	(4.79)	(7.43)	(-11.13)
BN	0.015**	0.102***	0.104***
	(2.29)	(3.25)	(4.46)
Sign Prediction	-	-	+
ΔDRET×BN	-0.263***	-0.905***	1.915***
	(-4.70)	(-4.97)	(13.33)
SIZE	0.001	0.101***	-0.168***
	(0.15)	(16.13)	(-37.76)
MTB	0.001*	-0.010***	0.006***
	(1.88)	(-4.06)	(3.91)
LEV	0.066***	0.446***	0.048
	(3.01)	(7.65)	(1.20)
/cut1		4.191***	-1.085***
		(84.67)	(-29.29)
/cut2		7.475***	-0.350***
		(100.77)	(-9.50)
/cut3		10.596***	0.223***
		(39.01)	(6.05)
/cut4		13.236***	0.959***
		(13.22)	(25.50)
/cut5			3.149***
			(64.00)
Constant	0.570***		
	(13.35)		
Observations	244,401	244,401	62,301
Year-month FE	YES	NO	NO
Firm FE	YES	NO	NO
Industry clustered SE	YES	NO	NO
Pseudo R-squared		0.00525	0.00950
Adjusted R-squared	0.095		

$$TEX_{i,t} = \beta_0 + \beta_1 \Delta DRET_{i,t-tlag} + \beta_2 BN_{i,t-tlag} + \beta_3 \Delta DRET_{i,t-tlag} \times BN_{i,t-tlag} + \beta_n CONTROLS_{i,t} + \epsilon_{i,t} \quad (3)$$

Auxiliary Analysis

- Managerial Incentives and Narrative Conservatism
  - Litigation
  - Compensation
  - Option grant
  - IPO
  - Reg FD (Kothari et al., 2009)
  - Different Sections of Narratives in 10-Q
- Alternative News Proxy
- Interaction Between Recognition and Narrative Conservatism
- Economic Implications of Narrative Conservatism

Discussion

- **Conclusions**
  - On average narratives have more number of words, greater marginal change of tone and shorter reporting time lag in response to bad news relative to good news, consistent with narratives being conservative.
  - In addition, we show that firms emphasize bad news more than good news via 10-Q filings, and are more likely to report larger number of 8-K filings and 8-K items per day in response to bad news comparing to good news.

- **Next Steps**
  - Revise the writing part.
  - Complete the (selected) auxiliary analyses.

Selected References

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