Narrative Reporting and Corporate Managers' Impression Management Practices

Ayah Ahmed Mohsen Mohamed Soliman

Abstract

This research addresses the use of various narrative disclosure outlets in today business environment. Furthermore, this research addresses the value relevance of narratives and impression management practices within the context of narrative reporting. Finally, this research addresses managers' incentives for impression management

1. Introduction:

Numerical presentation within the financial statements and the accompanying minimal footnote disclosure no longer stand on their own or serve as the primary source of financial information about a company. Today, reporting financial information above and beyond the financial statements is necessary to portray adequately a company's operations in an increasingly complex business world.

Consistently, Policymakers, most notably in the U.S, United Kingdom, Australia, and Canada, have long emphasized the importance of narrative disclosures in helping investors better understand and evaluate companies' financial performance and risks, and consistently a number of legislations and guidance encouraging companies to report a broader set of information beyond financial statements have evolved.

Meanwhile, accounting researchers have come to show a tremendous interest in both the nature and quality of the narrative information provided as well as managers' motivations and strategies for discretionary narrative disclosures and the capital market reaction thereto.

2. Corporate managers’ use of narrative disclosure outlets:

beyond quantitative, numeric information there is a large amount of unstructured textual information in corporate disclosures commonly referred to as narratives, ‘soft’, or unquantified information including footnotes to financial statements, earnings press release, conference calls transcripts, management discussion and analysis (MD&A), chairmen’s statements, initial public offering prospectuses, risk disclosures, takeover documents, CEO letters to shareholders, Corporate social responsibility statement (CSR), integrated and sustainability reporting.

Such various narrative disclosure outlets are usually disseminated through a range of formal and informal channels including, public relations documents, stand-alone reports, websites, and press statements. They are mostly user-friendly, that is they are simply written and usually visually interesting with clear headings and colorful pictures, tables, and charts. Ultimately they are intended to offer a mechanism that supports the creation of a more commercially attractive and differentiated picture of the business which can lead to a better investor understanding (PWC, 2007)[1], and that is basically why it has been argued that narrative sections attract wider readership than pure financial data.

The provision of narrative reporting information responds in the first place to the fundamental change in how a business creates value[2] and concerns that annual reports and particularly financial statements have lost much of it relevance to investors in assessing and understanding the performance and position of modern companies (Beattie et al., 2004; IASB, 2009[3]). The extant system of financial accounting, developed within a traditional-manufacturing environment, fails to capture the risk

[1] PWC (PricewaterhouseCoopers) 2007. Corporate reporting – a time for reflection: A survey of the Fortune Global 500 companies' narrative reporting. New York: PricewaterhouseCoopers. Available at : https://www.pwc.com/gx/en/corporate-reporting-services/pdf/reflection.pdf

[2] Achieving a competitive advantage in today business environment increasingly involves value creation processes that rely on intangible assets not recognized in the financial statements

[3] IFRSs around the world'. Available at http://www.iasb.org/About+Us/About+the+IASB/IFRSs+around+the+world.htm.

portfolio, investment opportunities, and interdependent organizational relationships of businesses operating in modern, increasingly knowledge-based environments (Rowbottom & Lymer, 2010).

Over time, following global accounting scandals, and the resulting regulatory attempts toward strengthening and broadening the corporate reporting model: from a focus on disclosing historical financial statement data to providing a wider scope for forward-looking financial and non-financial information that better aid decision making, an increasing number of companies have come to supply more narrative reporting information in their annual reports.

Supporting this notion, research by Campbell et al. (2006) found that the length of corporate annual reports has increased from 37 pages to 90 pages over the last four decades. The underlying argument of this research is that whilst some of this increase in volume may be due to some major regulatory events and legislations a considerable amount is due to the rise in narrative reporting section.

Consistently a survey by PricewaterhouseCoopers (PWC) in 2007[4] of the fortune global 500 companies' financial reporting

[4] PWC (PricewaterhouseCoopers) 2007. Corporate reporting – a time for reflection: A survey of the Fortune Global 500 companies' narrative reporting. New York:

has shown that 60 percent of pages in the primary filling are detected to narratives, contextual and nonfinancial information. By 2009, Deloitte's survey of narrative reporting in annual reports has shown that the proportionate volume of narrative reporting accounted for 52 percent of an average annual report. More recently Lo et al., (2017) argued that the narrative section has reached about 80% of an annual report.

This increasingly voluminous narrative reporting has supplemented and complemented financial statements by including prospective and retrospective information on a range of key issues: including the business model, strategy and structure, customers, human resources, innovation, brands, intellectual assets, supply chain, economic performance, operating performance, environmental, social and ethical performance, risk and uncertainties, and corporate governance.

Nevertheless, the increased volume of information does not necessarily result in information that is decision-useful. Number of studies (e.g. Merkl-Davies & Brennan, 2007; Merkl-Davies et al., 2011) within the context of narrative reporting, have made a distinction between the use of narrative reporting as an incrementally informative content that is aimed at improving

PricewaterhouseCoopers Available at : https://www.pwc.com/gx/en/corporate-reporting-services/pdf/reflection.pdf investors' decision making or otherwise as means of impression management that is aimed to distort users' perception of the company performance.

3. Incremental information content of narrative disclosures

The view of narratives as incremental information is a positive one: proponents of this view argue that narratives grant investors and others a better understanding of and a relevant insight into a reporting entities underlying economic fundamentals and thus have the potential to narrow the information gap between managers and outside investors while contributing to useful decision making. Here, managers are presumed to have economic incentives to engage in unbiased reporting as it enhances their reputation and compensation, particularly when investors offer premium investments for more credible disclosures.

The underlying assumption is that in an efficient market all market participants have rational expectations about future returns, which implies that, on average, the market is able to assess reporting bias. Accordingly, biased reporting would lead to a higher cost of capital and reduced share price performance. As managers' compensation is linked to stock price performance, managers have no economic incentives to engage in a strategic reporting behavior that would undermine disclosure quality (Merkl-Davies & Brennan, 2007).

In order to assess the information content of the narrative sections of annual reports, prior studies have used both the correlation with current or future economic fundamentals and the associations with contemporaneous market reaction. Using a Bayesian statistical learning approach, Li (2010), found that the tone of the forward-looking statements in a firm's MD&A is positively correlated with its future earnings and liquidity and has explanatory power incremental to other variables in predicting future performance. Furthermore, he has shown that MD&A disclosures mitigate the mispricing of accruals; when managers warn in the MD&A about the future performance implications of accruals, accruals are less likely to be mispriced by investors.

A further research by Merkley (2014) addressed how earnings performance relates to firms' narrative R&D disclosure and whether such disclosures are informative to market participants. Using a content analysis of the detail, tone, and readability of narrative R&D disclosures, the results have shown that managers adjust R&D disclosures based on earnings performance to provide relevant information rather than to obfuscate performance. Furthermore, this study provided evidence that since narrative R&D disclosures have a significant impact on sell-side analysts' behavior and information asymmetry, market participants respond to these disclosures and find them informative.

More recently, Boudt et al., (2018) have found evidence that the tone of earnings press releases provide value-relevant information to predict firm future profitability and explain cumulative abnormal returns at earnings announcement and that earnings press release are specifically more informative when the firm operates in an environment with high information asymmetry.

4. Impression management practices through corporate narratives

Given the wide latitude afforded to corporate managers with respect to narrative reporting regarding their content, timing, and style, concerns are often raised that some managers might engage in an opportunistic disclosure behavior using narrative disclosure outlets. Managers' use of discretion inherent in corporate narrative reporting to impress the reader favorably by means of manipulating the presentation and content of disclosed information is commonly referred to as "*impression management*".

As opposed to the incremental information perspective, the impression management interpretation of managerial discretionary disclosure strategies is based on the assumption that capital markets are inefficient and that investors are not able to assess managerial bias at least in the short term (Merkl-Davies & Brennan, 2007). Accordingly, managers engage in impression management practices with the intent of influencing the firm's share price, which can lead to increased compensation, via stock options, for managers. Other explanations for impression management practices included managers' intent of manipulating shareholders perception of the company social and environmental performance, image, and legitimacy

Regardless of what the underlying motive is, impression management can occur in different forms and the accounting literature has depicted a variety of impression management tactics and presentational methods used in corporate narratives. Particularly, Merkl-Davies & Brennan (2007) and Brennan et al. (2009) presented an extensive review of the impression management literature and identified seven discretionary narrative disclosure strategies that could lead to a misleading impression.

These strategies are classified into either (1) concealment or (2) attribution strategies. Concealment strategies are aimed to obfuscate poor company performance and underscore or emphasize successes. Attribution strategies, on the other hand, entail managers attributing positive organizational outcomes to internal factors ("entitlements") and negative organizational outcomes to external factors.

4.1. Concealment strategies:

Six strategies are used for concealment. Two of these obfuscate bad news by manipulating verbal information either by (i) Reading ease manipulation (i.e. making the text more difficult to read) or (ii) Rhetorical manipulation (i.e. using persuasive language). The remaining four strategies are used to emphasize good news by manipulating verbal and/or numerical information. This includes (iii) thematic manipulation; (iv) visual and structural manipulation; (v) performance comparisons; and (vi) choice of earnings number (selectivity).

4.1.1 Obfuscation of bad news:

a. Reading ease/ syntactical manipulation:

Prior studies analyzing reading ease manipulation are based on the presumption that managers use a difficult to read language to obfuscate corporate performance, especially negative performance. These syntactic studies assess readability in the context of narrative reporting using readability formulas such as Flesch, Fog, Lix, Fry Graph, Dale-Chall , Kwolek, Cloze, Texture, and Transitivity index, which compare a calculated score with a 'predetermined standards of written materials graded according to difficulty', ranging from very easy to very difficult.

One of the most commonly used in the accounting literature, the Flesch Reading Ease score, is based on two variables: the number of words in each sentence and the number of syllables in each word. It rates text on a 100-point scale where higher scores indicate more readable text. For instance, scores of 70 or more are an indication of an easily readable text. Scores between 30 and 50 are rated as difficult to read while those of 30 or less are considered to be highly difficult, and likely to be understood only by those with a higher level of education.

Another commonly used measure of readability, the Gunning Fog Index, or just Fog Index, is a function of the number of words per sentence plus the percentage of complex words, (i.e., having more than two syllables). This sum is scaled by a constant value (0.4) such that the resulting Fog value indicates the approximate number of years of formal education required to understand the text (Lo et al., 2017). Other readability formulas used, although differ in their specific calculation algorithms, all utilize word complexity and sentence length to evaluate reading ease.

b. Rhetorical manipulation

Rhetorical manipulation in accounting narratives also follows the obfuscation hypothesis, whereby management makes linguistic choices and uses rhetorical devices to persuade or impress readers and conceal negative firm performance. Rhetorical devices used include silence, antithesis, metaphor, wordplay, puns, questioning, plots, platitude, framing, and repetition (Brennan & Davis, 2013; Brennan et al., 2010; Davison, 2008).

To date, there has been little research examining rhetoric manipulation in financial reporting. To mention some, Brennan & Gray (2000) analyzed financial reporting practices relating to profit forecasts disclosed in takeover documents from the perspective of rhetoric and argument to provide an understanding of the ways in which management manipulate financial reporting to influence shareholders to support its strategies and goals.

Based on an examination of the plausibility and credibility of the language used and arguments offered in profit forecasts as well as the fairness and appropriateness of some of the techniques/methods of persuasion, the results have shown some evidence of strategic reporting behavior by management both in the accounting practices employed in preparing forecasts, in the variability of levels of disclosure and the choice of wording used in some disclosures

Yuthas et al., (2002) on the other hand, found that firms with both positive and negative earnings surprises exhibit a higher level of rhetorical features in narrative disclosure than firms without earnings surprises. Additionally, in their analysis of Enron's Letter to Shareholders after the bankruptcy, Craig & Amernic (2004) showed how metaphors of war, sport, and extremism and hyperbole are used to portray the firm's competitive advantage, despite mounting evidence to the contrary.

Later on, Brennan et al., (2010) examined the incidence, extent, and implications of impression management in hostile takeover defense documents issued by sample firms listed on the London Stock Exchange. Using manual coding techniques the findings of the research indicated that rhetorical manipulation is evident in hostile takeover defense documents. Attacking and defensive sentences were found to comprise the majority of the defense documents analyzed. Such sentences exhibited varying degrees of visual and rhetorical emphasis, which served to award greater or lesser degrees of prominence to the information conveyed by target company management.

4.1.2. Emphasis on good news:

a. Thematic manipulation:

Thematic manipulation is one of the commonly practiced impression management tactics that encompass the use of a biased positive tone (i.e. language, keywords, and statements)-as opposed to a neutral or negative tone- to convey and most likely to emphasize a positive view of an entity performance. Generally speaking, disclosure tone has a real impact on the decisions of stakeholders and numerous studies have proven that the tone of financial disclosures (e.g., earnings press release, MD&A, and conference call transcripts) increases short-term stock returns and reduces stock return volatility. Thus, it is worth mentioning that the use of inflated tone has the same deleterious effect as opportunistic reporting of quantitative information on shareholders' wealth in the long run and as well increases shareholders' litigation risk (Luo & Zhou, 2020).

The presence of certain language characteristics or the effective use of verbal tone and language bias in corporate narratives has been documented in a number of studies using different textual analysis methodologies including General Inquirer, Diction, Bayesian machine learning algorithm, and the Loughran and McDonald (2011) Word List. For instance, Guillamon-Saorin (2012) analyzed the themes in the headlines of annual results press releases reported by a large sample of Spanish listed companies. Coding the number of times positive and negative keywords occur, he provided evidence of persistent thematic manipulation in press release headlines. Companies, irrespective of whether they perform well or badly, are inclined to stress good news using positive keywords and downplay bad news to create a generally optimistic image of firm performance.

Using a large sample of annual earnings press releases from both PR Newswire and Business Wire, Hung et al., (2014) examined how abnormal positive tone relates to future firm performance in order to find out whether abnormal positive tone informs or misinforms investors, and the results have shown that abnormal positive tone is associated with poor future earnings and operating cash flows thereby supporting the opportunistic use of abnormal positive tone in earnings press releases.

Furthermore, in order to corroborate the use of abnormal positive tone in misinforming investors, they further examined whether the abnormal tone is more likely used in situations where managerial strategic incentives to manipulate investor perception are present (e.g. meeting or beating analysts forecasts, new equity offerings, merger and acquisition, and stock option grants) and the findings were consistent with managers using abnormally optimistic tone when incentives to bias perceptions upward are present

Consistently, Arslan-Ayaydin et al., (2015) investigated whether stock-based compensation schemes induce corporate managers to use inflated disclosure tone in earnings press releases. They found that regardless of what the underlying tone measure is, managers whose wealth are tied to stock prices appear to use a more aggressive optimistic tone in press releases and that this effect cannot be explained by differences in past performance, information asymmetry, industry or time fixed effects.

In the context of Management's Discussion and Analysis (MD&A) section of the 10-K filing, D'Augusta & DeAngelis (2020) examined whether the relationship between managerial disclosure tone and earnings performance depends on the performance of the firm relative to earnings expectations and managers' incentives to manage future performance expectations. They have found evidence suggesting that managers alter their tone to make future performance benchmarks easier to beat.

b. Visual emphasize and structural manipulation:

Visual and structural manipulation techniques are also intended to underplay negative performance and exaggerate positive performance. This could be achieved in a variety of ways including (a) visual emphasis using a number of visual techniques (for example, highlighting, font style and size, bullet points, bold text, color, tables, graphs, pictures, etc.); (b) Ordering or physical location of information (positioning good news first in documents, burying bad news in middle passages of text within documents); (c) Repetition; and (d) Reinforcement, which occurs when a piece of information is emphasized by using a qualifier (an additional word to add emphasis to a keyword (e.g. "strong growth" –"growth" is the keyword, "strong" is the qualifier)

These four techniques have been addressed in a number of studies. For instance, Cho et al., (2012) investigated whether firms use graphs in their sustainability reports for impression management purposes in order to present a more favorable view of their social and environmental performance. They have found that companies are far more likely to graph items showing favorable rather than unfavorable trends with the intention of portraying a more enhanced image of an entity performance

Hellmann et al. (2017) on the other hand examined the influence of textual presentation order on the judgments of non-professional investors and found that more emphasis is assigned to information presented last thereby suggesting that presentation order is an important determinant in shaping judgment and as such, may be used as an implicit impression management technique in various forms of financial communication to influence unsophisticated investor judgments. In sum, structural and visual effects of corporate narratives are perceived as a powerful medium for communication and can be effectively used for impression management.

c. Performance comparisons

In order to create a biased impression of an entity's performance, corporate managers might sometimes choose performance comparisons that portray their current performance in the best possible light. This is commonly achieved either by (1) selectively disclosing the lowest prior-period comparative benchmark earnings number in order to report the highest year-on-year increase in earnings; or (2) comparing performance indicators against favorable reference points, either time-series (past performance) or cross-sectional (industry averages and competitors) (Merkl-Davies & Brennan, 2007). In the extreme, If those in the financial reports do not allow for favorable comparisons, managers may create their own numbers instead (García Osama & Guillamón-Saorín, 2011).

d. Choice of earnings number (selectivity):

Another potentially misleading reporting practice is the selection of favorable earnings figures for inclusion in narrative disclosures, such as pro forma (or non-GAAP) earnings, and omitting others. The basic premise is that pro forma earnings numbers are earnings measures that exclude components of GAAP earnings and these exclusions are at the discretion of corporate managers. This ultimately supports an impression management motivation for such reporting. Based on a sample of S&P 500 firms, Marques (2010) have found evidence that managers attempt to influence readers' perceptions of the financial results of the firm by strategically giving more prominence to non-GAAP measures than to GAAP figures when the GAAP earnings number falls short of a benchmark but the non-GAAP earnings number does not.

Supporting these results, Isidro & Marques (2015) documented that in a sample of large European firms, managers use non-GAAP disclosures with the intent of deceiving external users. Particularly their analysis indicated that in more than 70% of the sampled firms, managers disclose non-GAAP earnings in earnings press releases that exceed GAAP earnings, and that more than 90 % of the sampled firms place equal or even greater emphasis on non-GAAP figures.

4.2. Attribution strategies:

Merkl-Davies & Brennan (2007) defined attribution as a defensive framing tactic that corporate managers strategically use in order to shifts the blame for negative outcomes away from themselves. Particularly, attribution entails managers attributing positive organizational outcomes to internal factors (such as company strategy, know-how, human resources potential) and negative organizational outcomes to external factors (such as the general business climate, inflation, foreign currency fluctuation, market prices, government policy).

Kimbrough & Wang, (2014) argued that managers presumably provide such attributions in earnings press releases to heighten (dampen) investors' perceptions of the persistence of good (bad) earnings news, thereby increasing (decreasing) the market reward (penalty) for good (bad) earnings news. Whilst, Zang &Aerts (2015) documented that failure to meet earnings thresholds, such as positive earnings, positive earnings change, and analyst earnings consensus, motivates the use of biased attributions in the performance-related MD&A sections of the 10-K filing of listed US firms.

5. Managers’ incentives behind impression management practices:

In addition to studying the use of different impression management tactics in the context of narrative reporting, researchers have also sought to understand what drives corporate managers to cultivate the image of an entity. Consequently, a number of explanations have been provided for corporate managers’ strategic disclosure practices in narrative reporting through the use of different theoretical perspectives including the economic; sociological; physiological; and critical perspective.

5.1. Economic perspective:

The most prevailing perspective on impression management motives in a corporate reporting context is driven by economics-based theories, particularly agency theory (Merkl-Davies & Brennan 2007). The agency theory suggests that corporate managers are motivated by a desire to present a self-serving view of corporate performance. More specifically, since corporate managers' compensation schemes (i.e. salary, bonus, stock options) are largely tied to the financial performance of the companies they work in, they presumably have economic incentives to disclose information that is intended to manipulate outsiders’ perceptions of corporate achievements and prospects.

This explanation has been made obvious in a wide range of studies supporting the utility maximization motive for impression management. For instance, Arslan-Ayaydin et al., (2015) proposed and consistently found that equity incentives increase managers' likelihood to opportunistically inflate the tone of the narrative section of earnings press releases and that is mainly to influence investors' expectations of future earnings and maximize the value of their own stock and option portfolios.

5.2. Psychological (social psychology) perspective:

Prior research adopting the social psychology perspective replaces the economic view of managers, whose corporate reporting decisions are based solely on the presumption of utility maximization, with a psychological view that takes managers' accountability to outside parties into consideration (Brennan & Merkl Davies, 2013). Psychological explanations of discretionary corporate narrative disclosures are based on the premise that managers' disclosure behavior is embedded in and dependent on the presence of organizational audiences (primarily shareholders) to whom managers are accountable for their decisions and actions (Oliveira et al., 2016).

Corporate narrative documents might serve as an accountability mechanism that addresses the concerns of external parties by providing an insightful description of managers' performance and decision behavior. As a consequence, in anticipation of how their actions would be evaluated, managers may be prompted to engage in impression management so as to counteract any undesirable consequences of information releases. Such undesirable consequences could be depicted in the form of unfavorable analyst reports and credit ratings, negative share price movements, and withdrawal of community support.

5.3. Sociological perspective:

The sociological perspective presumes that impression management arises from structural constraints exerted either by different stakeholder groups, consistent with the stakeholder theory or by the society at large, consistent with the legitimacy theory. The stakeholder theory on the one hand assumes that managers engage in impression management to manipulate the perceptions of a particular stakeholder group (such as employees, customers, government agencies, lobby groups, etc) or to respond to public pressure and media attention relating to a controversial issue or event (Merkl-Davies & Brennan, 2011).

On the other hand, underlying the legitimacy theory is the notion of a hypothetical "social contract" between the reporting entity and the society in which it operates. This social contract is used to represent the multitude of social rules, norms, and values that an entity has to meet while it continues to operate in the society. An entity's survival is then dependent to some extent on operating within the boundaries of societal norms. Hence, organizations are sometimes inclined to the use of strategic disclosure strategies to influence or even manipulate public perceptions about their legitimate status. In other words, impression management could be usefully employed to foster an organization's perceived legitimacy.

As such, prior research (e.g. Beelitz & Merkl Davies,2012; Bozzolan et al., 2015; Lee &Sweeney 2015) has identified a number of specific impression management tactics adopted by organizations to gain, maintain, or repair their legitimacy by seemingly aligning firms' norms and values with those of society, particularly in situations where firms face legitimacy threats, such as corporate scandals, product-safety issues or environmental disasters (Brennan & Merkl Davies, 2013).

5.4. Critical perspective:

The critical perspective is concerned with maintaining power and focuses on managers' desire of presenting their own view in an attempt to influence organizational audiences' perceptions of corporate influence and control. Consistently, prior studies adopting a critical perspective to explain the motives behind mangers' deceptive behavior, mainly focus on the presence of controversial issues and legitimacy threatening events, such as privatization, difficult financial circumstances, financial scandals and transformational changes" (Brennan & Merkl Davies, 2013, p.26).

These studies analyze how managers use the textual attributes of corporate narrative reporting with the aim of convincing organizational audiences of the validity, legitimacy or necessity of organizational changes, to depict financial scandals as isolated incidents, or to persuade organizational audiences of the exceptional nature of the circumstances resulting in the negative financial performance.

Summary and conclusion:

Prior literature addressing narrative disclosure has shown that it constitutes increasingly important issue of debate. The basic premise is that narrative disclosure strategies in corporate documents have been identified as potentially playing one of two contrasting rather than complementary roles: Incremental Information and Impression Management (Abdelrehim, Maltby & Toms, 2015).

On one hand, Proponents of the incremental information hypotheses (e.g. Demers & Vega 2014; Davis et al., 2012) commonly refer to agency theory and presumes that managers' primary intent is to reduce the informational gap between corporate insiders and external users by voluntary disclosing more decision-useful information. Doing so helps managers get access to external sources of finance at lower cost, maintain their own reputation, and maximize their compensation schemes.

On the other hand proponents of the impression management hypotheses (e.g. Solomon, 2013; Cooper & slack 2015) explains managers narrative reporting behavior as an opportunistic behavior where managers selectively disclose information for self-interest and manipulate the content and presentation of information in corporate documents with the purpose of distorting readers' perceptions of corporate performance and prospects.

If the true facts were disclosed, stakeholders' impressions might be less favorable. Hence, impression management seeks to control or modify the perceptions of stakeholders to present a self-serving view of corporate behavior. To a great extent narrative disclosures are at the discretion of managers and thus are subject to management interventions with regard to emphasis, reinforcement or omission of information.

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