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The Incremental Information Content of Tone Change in Management Discussion and Analysis

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Abstract

This study explores whether the Management Discussion and Analysis (MD&A) section of Form 10-Q and 10-K has incremental information content beyond financial measures such as earnings surprises, accruals and operating cash flows (OCF). It uses a well-established classification scheme of words into positive and negative categories to measure the tone change in a specific MD&A section as compared to those of the prior four filings. Our results indicate that short window market reactions around the SEC filing are significantly associated with the tone of the MD&A section, even after controlling for accruals, OCF and earnings surprises. We also show that the tone of the MD&A section adds significantly to portfolio drift returns in the window of two days after the SEC filing date through one day after the subsequent quarter s preliminary earnings announcement, beyond financial information conveyed by accruals, OCF and earnings surprises. The incremental information of tone change is larger the weaker is the firm s information environment.

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