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# Investor reactions to management earnings guidance attributions: The effects of news valence, attribution locus, and outcome controllability

Wei Chen [a], Jun Han [b], Hun-Tong Tan [c, *]

[a] School of Accounting, University of New South Wales, 2052, Australia
[b] School of Business, Faculty of Business and Economics, The University of Hong Kong, Hong Kong
[c] Division of Accounting, Nanyang Technological University, 639798, Singapore

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ABSTRACT

We conduct two experiments to investigate how investors react to attributions accompanying management guidance. In our first experiment, we find that investors provide lower earnings estimates when management attributes negative guidance news to external factors than internal factors. When the guidance news is positive, the locus (internal versus external) of the attributions has no effect on investors' earnings estimates. In our second experiment, we separate out the effect of the attribution's outcome controllability (controllable versus uncontrollable) from that of attribution locus in a negative guidance news setting. We find that investors provide higher earnings estimates for internal and outcome controllable attributions than for internal and outcome uncontrollable attributions attributions. Outcome controllability does not matter when attributions are external. Our study extends prior research by showing how the valence of management guidance and the characteristics of guidance attributions jointly influence investors' earnings judgments.



## 1. Introduction

Management earnings guidance (hereafter, management guidance) is the voluntary disclosure of earnings forecasts provided by managers. Managers have discretion over whether to provide causal attributions to accompany their guidance (hereafter, guidance attributions). Such attributions are part of management's voluntary disclosures, and the usefulness and effects of voluntary disclosure in the communication with investors have been among the key concerns of practitioners (FASB, 2001). Prior studies suggest that guidance attributions are strategic in that attributions relating to factors external (internal) to the guidance-issuing firms are more likely to accompany negative (positive) guidance news (Baginski, Hassell, & Hillison, 2000; Baginski, Hassell, & Kimbrough, 2004; Bettman & Weitz, 1983). However, it remains unclear how investors' judgments are interactively influenced by external/internal attributions (i.e., attribution locus) when they accompany guidance that provides positive/negative news (i.e., guidance that is higher/lower than the most recent consensus analyst forecast).

Investigating whether investors' judgments are jointly influenced by attribution locus and news valence is important because managers' decisions on the nature of attributions to provide (if any) are clearly strategic in that the characteristics of these attributions differ depending on whether the guidance news is positive or negative (Baginski et al., 2000). At the same time, the veracity of these attributions, generally classified as soft-talk disclosures, is difficult to verify for outsiders (Hutton, Miller, & Skinner, 2003).[1] Presumably, by providing external/internal attributions for negative/positive news guidance, managers aim to temper investors' negative reactions to bad news and strengthen investors' positive reactions to good news. Should this happen, there would be welfare implications for investors, particularly when the attributions are untruthful. On the other hand, psychology theory suggests that investors discount or even react negatively to attributions that are consistent with management incentives, which suggests that management's strategic intentions may not come to fruition (Carlston & Shovar, 1983; Forsyth, Berger, & Mitchell, 1981; Hirst,

* Corresponding author.
*E-mail address:* ahttan@ntu.edu.sg (H.-T. Tan).

[1] Soft-talk disclosures are defined as costless, nonbinding and non-verifiable (Barton & Mercer, 2005; Farrell & Rabin, 1996; Hutton et al., 2003). Verifiability refers to whether the statement is specific enough to be compared with subsequent realizations (Hutton et al., 2003).

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Koonce, & Simko, 1995; Hodge, Hopkins, & Pratt, 2006). Theory further suggests that the effect of attribution locus may be asymmetrical such that attribution locus may not matter for positive guidance as individuals' attributional search is generally truncated for positive news (Wong & Weiner, 1981). An investigation of whether attribution locus interacts with news valence in influencing investor judgment is therefore necessary. We also test the mechanism underlying this effect.

As a related issue, we examine how outcome controllability, defined as the extent to which managers are able to change or influence the outcome/consequence of their actions or events (Brickman et al., 1982; Karasawa, 1991; Schwarzer & Weiner, 1991; Tan & Lipe, 1997), moderates the effect of attribution locus on investors' judgments. Outcome controllability and its interaction with attribution locus are of interest because attributions can contain, and vary in, both aspects. Information about the controllability of future events is useful to evaluate the performance of managers and improve the welfare of both the principal and the agent (Antle & Demski, 1988; Crant, 2000; Feltham & Xie, 1994; Holmstrom, 1979). Further, without additional information about outcome controllability, lay beliefs are that internal/external attributions are more/less controllable by managers (Bettman & Weitz, 1983); but conceptually, attribution locus and controllability are distinct constructs (Weiner, 1979, 1985). If investors believe that internal attributions are controllable and infer so when management merely discloses an internal attribution without any statement about its controllability, investors may be drawing inappropriate conclusions that could bias their subsequent judgments. In addition, if management discloses both locus and controllability of attributions, investors may choose to ignore one of the dimensions based on the belief that one dimension is redundant or irrelevant in the presence of the other. Previous accounting research on attribution focuses on one dimension of attribution in isolation, such as attribution locus (Baginski et al., 2000, 2004; Elliott, Hodge, & Sedor, 2012) and controllability (Bol & Smith, 2011), and their joint effects remain unknown. Understanding the effects of these attribution dimensions in the management guidance setting is particularly important because managers have discretion in terms of how they frame an attribution.

We conduct two experiments to address our research questions. Our use of an experimental method allows us to hold constant the *quantitative* aspects of management's disclosure while varying only the *qualitative* disclosures, as well as to test the cognitive mechanism by which investors react to the attributions accompanying management guidance. It also enables an orthogonal partitioning of the attributions by attribution locus and outcome controllability, which would be more challenging to do using archival data. In particular, even though some combinations (e.g., an external and outcome controllable attribution) may occur less frequently in practice, the use of an experimental methodology allows us to disentangle these variables and theoretically test the combinations of variables that are underrepresented in practice. In addition, we hold firm characteristics constant across conditions. This eliminates the self-selection issues that potentially arise from an archival investigation; for instance, Baginski et al. (2004) document that firm characteristics differ systematically between those with and without attributions and those providing external and internal attributions.

We use a $2 \times 2 + 2$ between-subjects design in Experiment One with 119 Master of Finance students as participants. We hold constant the background information and the magnitude of management guidance news across conditions, and vary attribution locus (internal versus external) and the news valence of the management guidance (positive versus negative). We also add two control conditions in which no attribution is provided with the positive (negative) news guidance. Our results indicate that when management guidance news is negative, investors make lower earnings estimates when external attributions are provided than when internal attributions are provided. When management guidance news is positive, the locus of the attributions has no significant effect on investors' judgments. We posit that managers making self-serving attributions (e.g., external attributions for negative news) are deemed less credible, and we find support for this premise in that perceived management credibility mediates the above effect for negative guidance news. In contrast, we find no support for Baginski et al.'s (2004) argument that disclosure verifiability is responsible for the effects of attribution locus. We also find that investors perceive internal attributions to be more controllable by management than external attributions.

We conduct a $2 \times 2$ between-subjects Experiment Two with Amazon Mechanical Turk (MTurk) participants to separate out the effects of attribution locus and outcome controllability. We manipulate attribution locus (internal versus external) and outcome controllability (controllable versus uncontrollable outcomes) when guidance news is negative. Results from Experiment Two show that, investors' earnings estimates are higher when an attribution is internal and outcome controllable than when it is internal and outcome uncontrollable. There is no such effect of outcome controllability when the attribution is external. We also show that when an internal attribution is provided, outcome controllability enhances perceived management credibility and improves the perceived future prospects of the company, which in turn influence investors' earnings judgments. The findings of Experiment Two suggest that the two dimensions of attributions, locus and outcome controllability, interact in influencing investors' earnings judgments such that internal attributions accompanying the negative guidance have a positive effect on investors' estimates only when they are viewed as outcome controllable.

Our paper contributes to the literature on soft-talk disclosures in the following respects. First, our Experiment One contributes to this literature by testing the joint effect of guidance news valence and attribution locus. Prior literature has considered the effect of guidance news valence (e.g., Hutton et al., 2003) and attribution locus (e.g., Baginski et al., 2004) separately. Our results are partially consistent with those of Hutton et al. (2003) in the sense that attributions have no effect for positive earnings guidance. However, we additionally show that providing external attributions leads to more negative investors' reactions than providing internal attributions for negative guidance. Our results identify an important boundary condition to the results in Baginski et al. (2004): the effect of attribution locus is more likely to occur for negative guidance than for positive guidance. Furthermore, we identify perceived management credibility as the mechanism through which attribution locus has an effect on investors' judgments, and we find little support for the verifiability explanation.

Second, we contribute to the attribution literature, both in accounting and psychology, by showing that different dimensions of attributions interact in shaping investor judgments. We offer the first piece of evidence on the joint effect of these distinct attribution dimensions (here, attribution locus and outcome controllability) on investors' judgments. Our results imply that investors do not react only to the attribution locus, but that for the same internal attribution, their reactions differ depending on whether the attribution is controllable by management. Further, while prior studies show that outcome controllability can influence decision makers' evaluations (Bol & Smith, 2011; Tan & Lipe, 1997), we contribute to this literature by showing that the effect of outcome controllability is conditional on attribution locus. These findings are informative to managers who wish to understand the potential effects of their disclosure choices.