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Listening Without Prejudice: How the Experts Analyze Earnings Calls for Lies, Bluffs, and Other Flags

By STERLING WONG APR 18, 2012 2:40 PM

Through their words, tone of voice, and other verbal signals, executives often inadvertently reveal more than they want to. Here's what to listen for.

Earnings season has hit full-throttle, with blue chip companies **Coca-Cola** (KO), **IBM** (IBM), **Intel** (INTC), and **Johnson & Johnson** (JNJ), as well as others like **Goldman Sachs** (GS) and **Yahoo** (YHOO) all having reported their first-quarter results yesterday.

Following earnings season custom, many of these companies' CEOs and CFOs participated in conference calls in which they discussed their firms' financial results with analysts and investors.

Obviously, executives have self-interest in portraying the most flattering picture of their companies, which means that sometimes, the words of CEOs on earnings calls must be taken with a grain of salt.

Some CEOs are unable to mask the failings of their companies. In 2001, short-lived Enron CEO Jeff Skilling famously exclaimed, "Asshole!" to an analyst who questioned the now-defunct firm's financial statements.

However, most executives have been so well-trained in media relations that they would be able to successfully mask any slip-ups.

Take for example, the statements of then-Lehman Brothers CFO Erin Callan. In a March 2008 conference call, only days after Bear Stearns fell and was bought by **JPMorgan Chase** (JPM), Callan sought to reassure investors and analysts about the strength of Lehman, describing her firm's business with words like "strong," "great," and "incredibly" multiple times, while a word like "tough" was used only once. Of course, five months later, Lehman filed for bankruptcy, as its risky investments were brought to light.

That CEOs might be telling a fib or two on earnings calls is not news to seasoned hedge fund analysts. As IR Web Report notes, firms like Goldman and SAC Capital Advisors have long hired voice experts to analyze the voices of executives to detect if they give anything away.

One such expert is Chuck Rose, whose company, Mental Insights, helps companies conduct extensive behavioral research to achieve specific goals.

"Can we detect if someone is lying or fudging? No, we cannot," says Rose. What his company can do, instead, is to use a proprietary program to comprehensively examine quarterly and annual reports, earnings calls, news releases, speeches, regulatory filings, social media sentiment, and other documents to determine what a corporation is really saying or focusing on and how intense and consistent that focus is.

"You would look at words such as 'but,' 'if,' or anything of those things that often inadvertently get dropped in these earning calls," Rose told Minyanville when asked how one could tell if a executive is fibbing on an earnings call. "You have to look at the kind of enthusiasm executives have on the calls, and compare that enthusiasm against how they sounded in the past. If they were similarly accurate in the past, for example, then how accurate were their past statements?"

Another firm that does similar voice investigation work is Business Intelligence Advisors, or BIA, which has a team of retired CIA officers who look out for qualifiers like "honestly," frankly," or "basically," or cagey phrases such as "as I said before," or "to the best of my knowledge."

In his book, *Broker, Trader, Lawyer, Spy: The Secret World of Corporate Espionage*, CNBC reporter Eamon Javers described, in 2005, how BIA managed to spot looming troubles at **UTStarcom** (UTSI) through careful analysis of statements by the company's then-CFO. The firm duly reported to its client that it believed that UTStarcom executives were distressed about future revenues. Indeed, the following quarter, the company said it would not be able to meet revenue goals and saw its stock price plunge 30%.
Confirming the legitimacy of the work of Mental Insights and BIA is an academic study published in 2010 by Stanford's Rock Center for Corporate Governance. In coming up with their study, "Detecting Deceptive Discussions in Corporate Conference Calls," accounting professors David F. Larcker and Anastasia A. Zakolyukina looked at more than 16,000 transcripts of US quarterly earnings calls from 2003 to 2007, focusing on the question-and-answer back-and-forths between analysts and executives. What they found was that:

> Answers of deceptive executives have more references to general knowledge, fewer non-extreme positive emotions, and fewer references to shareholders value and value creation. In addition, deceptive CEOs use significantly fewer self-references, more third-person plural and impersonal pronouns, more extreme positive emotions, fewer extreme negative emotions, and fewer certainty and hesitation words.

For example, CEOs who are lying are more likely to use strong adjectives like "fantastic," or strong intensifiers like "emphatically," "splendidly," and "unquestionably," rather than words like "good" or "solid." Instead of using personal pronouns such as "I" or "we," which establish a stronger personal tie, they will use "the company" or "the team."

Also, contrary to intuition perhaps, lying executives are also less likely to stammer or use "um" or "er," which of course means that they were thoroughly prepped ahead of time to dish out rehearsed sound bites.

It's not just the words executives use that can give their lies away, but also the tone of their voice. An Israel-based firm, Nemesysco, came up with an automated program called Layered Voice Analysis Technology, which was able to analyze changes in voice tones to identify positive and negative emotions.

Two Duke University accounting professors, William Mayew and Mohan Venkatachalam, utilized the Nemesysco software to look at more than 1,600 recorded earnings calls from 2007. Their study, "Analyzing Speech to Detect Financial Misreporting," found that the verbal cues of executives could predict how a firm would perform financially in the near future. If CEOs' voices project a positive emotional state, then it is likely that their companies will report higher-than-forecasted earnings in the next six months. Conversely, expressions of negative emotions could mean a higher likelihood of earnings forecast misses in the next three quarters.

Of course, while these two academic studies may prove very helpful to investors hoping to gain deeper insights from earnings calls, they have to be taken with a grain of salt since both report accuracy rates of about 60%.

Additionally, it is a continual cat-and-mouse game between poker-faced (or in this case, poker-voiced) CEOs and bluff-catching analysts and investors. While the latter continue to employ the latest technology and expertise to analyze earnings calls, the former undoubtedly is constantly improving vocal performances through extensive public relations coaching.

Perhaps that is why CEOs can command such astronomical salaries these days. Not only do they have to be able to make smart decisions, they also must essentially have a super-human ability to give nothing away -- either through speech or emotion -- on earnings calls.

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No positions in stocks mentioned.