



# Discussion of “Cash flow asymmetry: Causes and implications for conditional conservatism research”<sup>☆</sup>



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## ABSTRACT

Accounting researchers should not view CHT's analysis as the solution to our collective problem of being able to measure conditional conservatism. CHT provide evidence about earnings asymmetric timeliness and an accruals-based measure of asymmetric timeliness that is useful for evaluating construct validity. In some cases, CHT's evidence will translate directly to another researcher's setting. In other cases, CHT provide useful guidance for researchers to follow in conducting their own construct validity analysis. But it is ultimately the responsibility of each researcher to conduct his own construct validity analysis specific to his research question and sample.

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## 1. Introduction

Tests of the economic role of conditional conservatism, defined as the outcome of an accounting system with asymmetric recognition of news, require the researcher to propose a proxy for conditional conservatism. The asymmetric timeliness estimate from a regression of earnings on returns proposed by Basu (1997) is one of the most commonly used measures of conditional conservatism. While Basu's conceptualization of conditional conservatism can be viewed as a breakthrough,<sup>1</sup> his asymmetric timeliness (AT) measures should be viewed only as a first step in the difficult process of developing valid empirical constructs for conditional conservatism. Ongoing research is essential to clarify and refine our understanding of the construct and improve our measures of it.

In that spirit, CHT should be viewed as only one element of a construct validity assessment of conditional conservatism.<sup>2</sup> Researchers should *not* view CHT's contribution as the development of a quick-fix solution to measuring conditional conservatism, and I appeal to researchers to read past the last sentence of the abstract and not to blindly follow the

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<sup>1</sup> Ball et al. (2013a) note that Basu (1997) conceptualized conditional conservatism as the asymmetry in the way that new information is conveyed through earnings as a result of differential verification standards. They describe his formulation of the concept as a “breakthrough” and argue that a market-based measure is a natural way to measure this conceptualization.

<sup>2</sup> Pioneers of construct validity techniques expressed their ideas about how the process should develop in different ways but the basic idea is the same: researchers should take a 360 degree view of a construct and accumulate evidence to infer its meaning. For example, Cronbach and Meehl (1955) suggest that construct validity involves elaborating the “nomological network” of a construct, which includes identifying how the construct relates to other constructs or observable properties. Early in the process, the network will be limited with few connections. Through time, ongoing research should attach a construct to more and more facts or other constructs. Campbell and Fiske (1959) discuss the necessity of showing convergent and discriminant validity and propose the multi-trait multi-method matrix.

recommendation: “Going forward, we recommend researchers use accruals-based asymmetric timeliness measures when testing for conditional conservatism.” It would be irresponsible for a researcher to effectively outsource the task of construct validity analysis to CHT by using accruals AT as a proxy for conditional conservatism purely based on CHT’s recommendation in the abstract. Each individual researcher bears the responsibility for developing a clear understanding of the dimension of conditional conservatism that is the object of interest in his study and for reviewing established metrics, including perhaps an accruals-based AT measure, as possible proxies. CHT’s findings can contribute to the ongoing (and unending) process of improving measurement of conditional conservatism, and their analysis can guide researchers in how to conduct a construct validity analysis, but researchers should not view CHT as the final answer.

CHT offer two caveats to their recommendation to use accruals AT as a proxy for conditional conservatism, but they appear only at the end of the introduction. The first caveat is: “In recommending accruals-based measures of DT, we are not claiming that this measure should be used in all conservatism studies going forward. Indeed, it seems the accruals-based approach is likely to be inappropriate in several important settings that are examined by accounting researchers...” This caveat is essential because there is a potential for slippage between CHT’s conceptualization of conditional conservatism and the use of the term “conditional conservatism” in the literature. CHT consider conditional conservatism to be the outcome of an accounting system that involves the application of “...differential verification thresholds for recognizing good news vs. bad news about *expected* future cash flows (i.e., *unrealized* gains versus *unrealized* losses...” (p. 3, emphasis theirs)). Although CHT’s definition is reasonable, this conceptualization is not used universally throughout the literature. Consider, for example, the discussion in Ball, Kothari, and Nikolaev (BKN, 2013a). They describe the Basu metric as deriving from conditional conservatism resulting from firm fundamentals and accounting discretion and even the interaction between the two. Although both CHT and BKN use the same term – “conditional conservatism” – BKN’s notion of what the Basu measure could represent is clearly different.

Researchers must carefully assess their own research setting to determine the distinct notion of “conditional conservatism” that is the object of interest in their study. A theory may use the words “conditional conservatism,” but if the theory is based on asymmetric timeliness due to fundamentals, or due to the interaction between fundamentals and the application of the accounting rules, then isolating the accruals component of asymmetric timeliness as a proxy for “conditional conservatism” could be inappropriate. As an example, consider theories about the role of “conditional conservatism” and debt covenants. Given that debt contracts are generally written on total earnings rather than just accruals, these theories are likely to assume that creditors factor CFO AT into the determination of the covenants, regardless of whether they view CFO AT as an indication of “conditional conservatism.” As another example, consider models that assume that cash outflow realizations are more controllable than cash inflow realizations,<sup>3</sup> in which case asymmetric timeliness in cash flows is relevant to the decision maker. In summary, the concept of conditional conservatism that underlies the predictions being tested should determine whether including cash flow AT is appropriate to test any given study’s predictions.

The remainder of my discussion is dedicated to expanding on CHT’s second essential caveat related to using accruals AT as a proxy for conditional conservatism (i.e., excluding CFO AT from Basu’s return-based metric): “Moreover, we are not claiming that CFO asymmetry is the only factor that researchers may need to control for when testing conjectures about conditional conservatism.” In Section 2, I provide a condensed summary of CHT’s findings. The nuances of the findings, and the details of their sample and setting, are important when considering how and whether to “control for” CFO asymmetry by using accruals AT as a proxy for conditional conservatism. In Section 3, I describe the findings of three studies that are part of the larger literature on the Basu metric as a measure of conditional conservatism. These summaries provide examples of factors other than CFO asymmetry that researchers may need to control for, and on the flip side, they illustrate that controlling for CFO asymmetry may eliminate legitimate sources of conditional conservatism. Bear in mind that my coverage of the literature is incomplete. There are numerous studies on conditional conservatism, in general, and the Basu return measure, in particular. The scholarly debate about the Basu return measure as a proxy for conditional conservatism is vibrant, as it should be. I cite a limited number of examples; I apologize to the authors of the many papers I do not include.

## 2. Summary of CHT’s findings

This section provides a condensed summary of CHT’s key findings, highlighting the details and nuances of individual findings that are relevant for assessing the use an accruals-based AT proxy for conditional conservatism. Before considering CHT’s findings, however, take note of the sample to which the findings relate. The CHT sample excludes financial institutions. This exclusion is sensible because proxies for constructs like growth opportunities (e.g., sales growth or market-to-book ratios) and financial distress (e.g., leverage) that are commonly used in other sectors are not reliable proxies for the same constructs in financial institutions. In addition, CHT’s prediction that firms in the early life cycle stage will exhibit greater CFO AT does not translate well to the business models of financial institutions. CHT also exclude firms with negative book value of equity. This exclusion is noteworthy because firms with negative equity could be an important component of

<sup>3</sup> CHT acknowledge this alternative explanation for cash flow asymmetry in Section 7. Table 10 shows that that CFO AT is not significantly different in write-down years vs. non-write-down years although accruals AT (obviously) is.

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