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Discussion of "Asymmetric timeliness of earnings, market-to-book and conservatism in financial reporting"☆

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Abstract

Roychowdhury and Watts [2007. Asymmetric timeliness of earnings, market-to-book and conservatism in financial reporting. Journal of Accounting and Economics.] provide a thought-provoking discussion of an important topic and consider a controversial role of accounting inconsistent with the valuation perspective of accounting currently adopted by standard setters. The paper uses a contracts-based view of accounting to explain the empirical relation between two measures of conservatism, the market-to-book ratio and asymmetric timeliness. Although the predictions from their framework are consistent with the previously documented negative correlation between these measures, suggesting this criticism of asymmetric timeliness may be misguided, I will be surprised if their paper eliminates the controversy over these measures of conservatism.

JEL classification: M41; M44; M47; G12; G34

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1. Introduction

Despite a history that can be traced back to the late Middle Ages, accounting conservatism remains controversial for a variety of reasons. One controversy surrounds

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the empirical measures of conservatism in part because of a negative correlation between the market-to-book ratio and the Basu (1997) asymmetric timeliness measure. The mission of Roychowdhury and Watts (2007) is to use a contracts-based view of accounting to explain the relation between these alternative measures of conservatism.

Roychowdhury and Watts (2007) note that it is difficult to assess the validity of empirical proxies in the absence of an economic theory of conservatism. They argue that the observed negative correlation between the beginning market-to-book ratio and asymmetric timeliness of earnings can be explained using the conservatism framework developed by Watts (2003). Specifically, Roychowdhury and Watts (2007) state that "the role of accounting is to report the market value of net assets [exclusive of rents] available for interim distributions to claimants. Accounting, in our framework, ignores changes in rents and employs, asymmetric verification standards to recognize losses versus gains in net assets." The authors first use this framework to explain the negative correlation between timeliness and the market-to-book ratio measured at the beginning of the timeliness estimation horizon. Then they use the framework to make predictions about the correlation between timeliness and the market-to-book ratio measured at the end of the timeliness estimation horizon and about how this relation will depend on the length of the timeliness estimation horizon.

While the authors' results are consistent with predictions generated by their framework for conservatism, in this discussion I play devil's advocate by suggesting that there may be alternative empirical explanations for why these two conservatism constructs are correlated in the way that they are. I do not attempt to create a comprehensive set of alternatives or to construct a theory that links these alternative explanations.

Understanding the relation between market-to-book and asymmetric timeliness is clearly an important first step in evaluating these two commonly used conservatism measures. I believe that this article, without question, will make converts, but I will be surprised if it eliminates the controversy over empirical measures of conservatism. Given that the economic rationale for conservatism has important implications for a wide variety of accounting standards-setting issues, the ultimate goal of this research must be to measure conservatism convincingly enough to infer the role of accounting from the measured characteristics.

2. Relation between beginning market-to-book and timeliness

Based on the argument that accounting should measure separable net assets, Roychowdhury and Watts (2007) argue that both market-to-book and asymmetric timeliness measure conservatism with error and that understanding the nature of the error allows for predictions about the empirical relation between these two measures. Specifically, the market value of equity includes not only the market value of separable assets but also the market value of growth options and non-competitive rates of return. Similarly, the inclusion of changes in these rents in the returns variable that is the independent variable used in estimating the asymmetric timeliness coefficient will result in estimation error in this measure. While their theory provides one possible source of measurement error, there are undoubtedly others.

The negative correlation between these two measures, while consistent with a net separable assets benchmark for conservatism, could also be due to any other source of measurement error in market values. For example, Roychowdhury and Watts (2007) do