Chapter 3 Accruals and Conservatism

3.1 Introduction

In this chapter, I discuss the role of accruals for the timely recognition of unrealized gains and losses. As stated in the previous chapter, the primary role of accruals is to overcome problems with measuring firm performance when firms are in continuous operation. Realized cash flows have timing and matching problems that cause them to be a ‘noisy’ measure of firm performance. Accruals alter the timing of cash flows recognition in earnings to mitigate the noise in cash flows. This results in a negative correlation between accruals and cash flow from operations (Dechow, 1994).

However, accruals are not only used to reduce noise in earnings, but are also used for unrealized gain and loss recognition (Ball and Shivakumar, 2005 and 2006; Kothari et al., 2005). The economic gain or loss during a period can be thought of as the current-period cash flow plus or minus any upward or downward revision in the present value of expected future cash flows. By definition, timely gains and loss recognition must occur around the time of revisions in expectations of future cash flows. The revision in cash flow expectations normally will be made prior to the actual realization of those losses in cash, so timely recognition of an economic loss in accounting income generally requires accounting accruals. Examples of timely recognition involving working capital assets and liabilities include gains and losses on trading securities, inventory write-downs due to factors such as spoilage, obsolescence or declines in market value, receivables revaluations, and provisions for operating costs arising from adverse events in the current period. Examples of timely recognition involving long term assets and liabilities include gains and losses on trading securities, restructuring charges arising from attending to failed strategies or excessive headcounts, goodwill impairment charges arising from negative-net present value (NPV) acquisitions, and asset impairment charges arising from negative-NPV investments in long term assets (Ball and Shivakumar, 2006). In contrast to noise-reducing operating accruals, gain and loss accruals are a source of positive correlation between accruals and current-period operating cash flow.

Ball and Shivakumar (2006) show that accruals are indeed used to reflect the timely recognition of economic losses. This role of accrual accounting has important implications for the interpretation of accruals. Timely loss recognition has the opposite effect of the noise mitigating role discussed by Dechow (1994). It increases the variance of earnings conditional on the variance of periodic cash flows, by including capitalized losses in earnings. By increasing the volatility of accruals, and of earnings relative to cash flows, timely loss recognition could be
mistaken for poor earnings quality (e.g., Leuz et al., 2003; Graham et al., 2005). Ball and Shivakumar (2006) instead argue that timely gain and loss accruals directly improve the timeliness of accounting earnings and that timely recognition through accounting accruals actually improves reporting quality. Ball and Shivakumar (2005) argue that timely gain recognition is less of a concern than timely loss recognition. Ball and Shivakumar state that “the reason for this asymmetry is not totally clear. Ball and Shivakumar (2005) argue that the demand for timely loss recognition arising from debt and compensation contracting exceeds the equivalent demand for timely gain recognition. Because accrual accounting is a costly activity unrealized gains and losses are not costlessly observable, involving accounting, independent verification, and litigation costs), the optimal quantity of timely loss recognition exceeds that of timely gain recognition (p. 209)”.

Research in asymmetric timely gain and loss recognition focuses predominantly on timely loss recognition, and less on timely gain recognition. Ball and Shivakumar (2005) provide three related reasons why timely gain recognition is of lesser concern. First, there is lower demand for timely gain recognition. Managers have a greater incentive to disclose timely information about unrealized economic gains than unrealized losses (they can realize gains by selling), so external parties are likely to demand an offsetting asymmetry in the financial statements (i.e. timely loss recognition). Second, accounting rules and practice are fundamentally asymmetric, and third, empirical evidence is consistent with timely gain not being a priority in accounting. Throughout this chapter and the remainder of the thesis, the focus will therefore be on the timely recognition of losses.

3.2 Timely loss recognition, Conservatism and Accruals

Timeliness of loss recognition is a summary indicator of the speed with which adverse economic events are reflected in both income statements and balance sheets. It is considered to be an important attribute of financial reporting quality (Ball and Shivakumar 2005). The demand for reporting quality is based on the information asymmetry between management and stakeholders of the company (e.g. shareholders and lenders). Stakeholders require timely measures of performance for compensation purposes, debt agreements and other contracts with the firm. The principles of accrual accounting are used in financial reporting to provide a timely measure of

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12 Ball and Shivakumar (2005) consider timely loss recognition an important attribute of reporting quality. Timely gain and loss accruals directly improve the timeliness of accounting earnings, and thereby (subject to cost considerations) increase its efficiency in debt and compensation contracting (see Basu, 1997; Ball et al., 2000; Ball and Shivakumar 2005).
performance. Via the use of accruals, accounting standards supply flexibility in financial reporting quality to meet demand for reporting quality.

Accounting income is the main indicator of financial reporting. Accounting income consists of the cash flow generated by the operations of a firm, and accruals adjustments on cash flow from operations based on expectations of cash flows. Accounting income differs from economic income, which can broadly be defined as the change of the market value of equity, adjusted for dividends and capital contributions (Ball and Shivakumar, 2005). Economic income incorporates both current period cash flow and any revision in the present value of expected future cash flows. The economic gain or loss during a period can be thought of as the current-period cash flow plus or minus any upward or downward revision in the present value of expected future cash flows.

Accounting recognizes (economic) income under two broad models: deferred and timely recognition. Deferred recognition largely ignores revisions in expectations and awaits the realization of the revised cash flows themselves. Timely recognition incorporates unrealized gains or losses in income (and hence the balance sheet) on an accrued basis, for example as inventory write-downs or as restructuring or asset impairment charges.

There is a difference in accounting practice in the timely recognition of losses and the timely recognition of gains. Financial reporting normally modifies the revenue recognition rules by adopting a lower verification standard for information about decreases in expected future cash flows (i.e. economic losses) than for increases (i.e. economic gains) (Basu, 1997). Thus, the accounting treatment of gains and losses is asymmetric when concerning the verification requirement. This difference is induced by the conservatism principle of accounting. In fact, Watts (2003) defines conservatism as the differential verifiability required for the recognition of profits versus losses.
Conservatism is an important convention of US GAAP financial reporting. It implies the exercise of caution in the recognition and measurement of income and assets. However, despite its central role in accounting theory and practice, no authoritative definition of conservatism exists (Givoly and Hayn, 2000). As a result, different interpretations of conservatism have developed in the literature. Givoly and Hayn argue that the only 'official' definition is that offered in the glossary of Statement of Concepts No. 2 of the FASB, namely, that conservatism is 'a prudent reaction to uncertainty to try to ensure that uncertainty and risks inherent in business situations are adequately considered'. However, this definition does not specify the nature of the 'prudent reaction' called for by conservatism nor does it explain how such a 'reaction' may ensure that risks are 'adequately considered' (Givoly and Hayn, 2000).

Absent a definitive definition of conservatism, more distinct definitions have developed. Traditionally, accounting conservatism is defined by the adage “anticipate no profit, but anticipate all losses” (Bliss, 1924). Anticipating profits means recognizing profits before there is legal claim to the revenues generating them and that the revenues are verifiable. Conservatism does not imply that all revenue cash flows should be received before profits are recognized—credit sales are recognized—but rather that those cash flows should be verifiable (Watts, 2003).

In the recent literature, two related but distinct definitions of conservatism have developed. One definition of conservatism is an accounting bias toward reporting low book

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13 Researchers advance a number of explanations for conservative reporting; all of them suggest that conservatism benefits users of the firm's accounting reports (Watts, 2003). One explanation is that conservatism arises because it is part of the efficient technology employed in the organization of the firm and its contracts with various parties. Under this contracting explanation, conservative accounting is a means of addressing moral hazard caused by parties to the firm having asymmetric information, asymmetric payoffs, limited horizons, and limited liability. Conservatism can contain management's opportunistic behavior in reporting accounting measures used in a contract. For instance, in debt covenants, conservatism reduces the likelihood management will forgo positive net present value projects, overstate earnings and assets, and make what is effectively a liquidating dividend payment to shareholders at the expense of debt holders. In compensation contracts, conservatism reduces the likelihood that managers will exert effort to overstate net assets and cumulative earnings in order to distribute the net assets of the firm to themselves instead of exerting effort to take positive net present value projects. In corporate governance, conservatism provides timely signals for investigating the existence of negative net present value projects and taking appropriate actions if they exist. Conservatism protects the shareholders' option to exercise their property rights. Shareholder litigation is another source of conservatism. Shareholders' right to sue for financial statement misrepresentation creates a demand for conservative accounting to limit litigation losses stemming from allegations of overstated net assets or income. Financial reporting standard setters and regulators have their own incentives to favour conservative accounting and reporting. Regulators demand conservative accounting because they face political costs when investors suffer losses due to alleged net asset overstated. Other explanations for conservatism are taxation, earnings management (management understates assets by taking excessive charges and excessive write-offs, perhaps in a "big bath," in order to overstate earnings in the future) and the option that management elects to abandon operations that are not profitable (Watts, 2003).
values of stockholder equity (and hence, if clean surplus accounting is being followed, low average net incomes). Watts and Zimmerman (1986) provide the following definition:

“Conservatism means that the accountant should report the lowest value among the possible alternative values for assets and the highest alternative value for liabilities. Revenues should be recognized later rather than sooner and expenses sooner than later (pp. 205-206).”

This kind of conservatism is called ex *ante conservatism* (Richardson and Tinaikar, 2004), also called *news-independent conservatism* (Chandra et al., 2004) and *unconditional conservatism* (Beaver and Ryan, 2005). Ex ante conservatism stems from the application of generally accepted accounting principles (GAAP) or policies that reduce earnings independent of current economic news. As a result, these aspects of the accounting process determined at the inception of assets and liabilities yield expected unrecorded goodwill. Examples include the immediate expensing of advertising expenditures and research and development (R&D) expenditures and other internally developed intangibles, even if they are associated with positive expected future cash flows, depreciation of property, plant, and equipment that is more accelerated than economic depreciation (accelerated depreciation), and historical cost accounting for positive net present value projects.

In his seminal paper, Basu (1997, p. 4) makes an important contribution to the understanding of the conservatism concept. He defines conservatism as follows:

“I interpret conservatism as capturing accountants’ tendency to require a higher degree of verification for recognizing good news than bad news in financial statements. Under my interpretation of conservatism, earnings reflect bad news more quickly than good news.”

His definition stresses the asymmetric timeliness of loss recognition. This second kind of earnings conservatism is also called *ex post conservatism* (Richardson and Tinaikar, 2004), *news-dependent conservatism* (Chandra et al., 2004) and *conditional conservatism* (Beaver and Ryan, 2005). The additional requirement of this conditional conservatism definition is that the reduction in accounting income reflects a contemporaneous economic loss. This requirement is not satisfied by expensing early, by deferring revenue, or by under-reporting income or book value on a regular basis (e.g., creating excessive provisions in all years), none of which is correlated with contemporaneous real income. Asymmetric loss recognition or ex post conservatism implies more timely earnings recognition of bad news than of good news. In this case book values are written
down under sufficiently adverse circumstances but not written up under favorable circumstances, with the latter being the conservative behavior. An important consequence of conservatism's asymmetric treatment of gains and losses is the persistent understatement of net asset values.

The difference in definitions is most apparent in Basu’s primary research design, which studies the asymmetric incorporation of economic gains and losses proxied by positive and negative stock returns over the fiscal year, in current-year accounting income.\(^\text{14}\) Examples of asymmetric loss recognition under US GAAP include the lower-of-cost-or-market rule for inventories, write-downs of goodwill following impairment testing, and the asymmetric recognition of contingent losses and contingent gains. Generally, accounting principles under US GAAP require write-downs to recognize bad news regarding inventory, goodwill, and loss contingencies, but prohibit write-ups to recognize good news (See also Ball and Shivakumar, p. 213).

The two types of conservatism have many of the same purposes, including capturing investors’ and others’ perceived asymmetric loss functions, minimizing firms’ litigation, tax, or regulatory costs, and enabling accounting and industry regulators to minimize economic instability and avoid criticism. The literature on unconditional conservatism puts greater emphasis on the difficulty of valuing certain types of economic assets and liabilities and determining their effects on future income. The literature on conditional conservatism puts greater emphasis on improving contracting efficiency given managers’ incentives to report upward-biased accounting numbers (Beaver and Ryan, 2005).

Beaver and Ryan (2005) examine the interactions between the two types of conservatism and observe that unconditional (ex ante) conservatism in prior periods preempts conditional (ex post) conservatism in later periods: if a firm is ex ante conservative in writing off an expenditure in one period, there will not be any capitalized amount on its balance sheet to write off in response to bad news later, ex post\(^\text{15}\). Also important but less obvious, the model captures the fact

\(^{14}\) Chandra et al. (2004) point out that because ex ante conservatism is independent of current-period news, one expects the application of ex ante conservatism to lower the intercept in a regression of earnings on returns but not to affect the slope coefficient. Thus, the implementation of ex ante conservatism does not result in any direct relation in the current period between earnings and either negative or positive returns, or in any difference between the two relations. However, for ex post conservatism, the application of ex post conservatism results in the slope coefficient in the regression of earnings on returns being higher for firms with negative returns (bad news firms) than for those with positive returns (good news firms), provided that equity prices efficiently impound bad and good news (see also Pae et al., 2005).

\(^{15}\) For example, earnings cannot recognize bad news with asset impairment charges if ex ante conservatism resulted in not recognizing a now impaired asset to begin with. In contrast, suppose that the firm is not ex ante conservative but instead capitalizes an expenditure as an asset in one period. Then, if there is bad news relating to the projected benefits associated with the asset in a later period, one expects to observe ex post conservatism in the later period under standard asset impairment accounting (Pae et al., 2005).
that conditional conservatism resets the cost bases of net assets and so affects subsequent unconditional conservatism.

The Beaver and Ryan (2005) model and subsequent simulations demonstrate that the piece-wise linear analysis in Basu (1997) is only a first-order approximation of a much richer dynamic process. In his discussion of Beaver and Ryan (2005), Basu (2005) argues that since conditional conservatism strongly influences the properties of accounting numbers, a better understanding of its underlying dynamics is likely important to all accounting constituencies. In particular, empirical researchers stand to benefit from better-specified models for event and association studies, earnings time-series and forecasting studies, and “discretionary” accruals and earnings management tests, based on a richer description of fundamental accounting processes.

One possible outcome of this observation is that sudden earnings reversals which have been identified as earnings management are in fact the effect of conditional conservatism on the balance sheet of previous low unconditional conservatism firms. As Givoly and Hayn (2000) point out, the sum of earnings over the life of the firm (or over a full business cycle) must be the same regardless of the accounting choice. Therefore, what constitutes conservatism in one period may lead to non-conservative results in subsequent periods. Likewise, since conditional conservatism can be reflected in accruals, “discretionary” accruals could also reflect accounting conservatism instead of earnings management.

3.3 Measuring of accounting conservatism

There seems to be different vantage points of what constitutes conservatism. As a result, several empirical measures have been used to gauge the degree of accounting conservatism. In general, researchers use four types of measures to assess conservatism: (1) net asset measures (e.g. book-to-market ratio, see Pae et al, 2005 and Watts en Roychoudary, 2005); (2) earnings/stock returns relation measures (explanatory power regression stock prices earnings change); (3) earnings measures (earnings slope, earnings distribution); (4) accrual measures. All measures rely on the effect of conservatism’s asymmetric recognition of gains and losses on reported accounting numbers, in particular net assets, earnings, and accruals.
3.3.1 Net asset measures

Net asset measures of conservatism are based on the balance-sheet-oriented definition of conservative accounting suggested by the theoretical framework developed by Feltham and Ohlson (1995). They argue that conservative accounting concerns the valuation of operating assets relative to the present value of expected cash flows. The market value is considered a proxy for the present value of expected cash flows, so this definition views accounting as being conservative if the expected value at time $t$ of the excess of the market value over the book value of the firm's equity at time $t+T$ is greater than zero as $T$ approaches infinity. This notion of conservatism points to the use of the market-to-book ratio as a proxy for the degree of conservatism. Although the market values of the assets and liabilities comprising net assets change every period, all these changes are not recorded in the accounts and reflected in financial reports. Under conservatism, increases in asset values (gains) that are not sufficiently verifiable are not recorded, while decreases of similar verifiability are recorded. The result is that net assets are understated and thus carried below market value. A market-to-book ratio greater than one indicates conservative accounting and, other things being equal, an increase in the ratio over time suggests an increase in the degree of reporting conservatism. Watts and Roychoudary (2005) show that the market-to-book is an indicator of conservatism.

3.3.2 Earnings/ Stock return relations

Stock market prices tend to reflect asset value changes at the time those changes occur whether those changes imply losses or gains in asset value, that is, stock returns tend to be timely. Since conservatism predicts recognition of accounting losses on a more timely basis than gains, accounting losses are predicted to be more contemporaneous with stock returns than accounting gains. Basu (1997) predicts that stock returns and earnings tend to reflect losses in the same period, but stock returns reflect gains earlier than earnings. To provide estimates of his conservatism measure, Basu (1997) runs a regression of annual earnings on stock returns of the same year. He predicts a higher coefficient of stock returns and a higher $R^2$ from this regression for a sample of firms with negative stock returns than for a sample of firms with positive returns. Using U.S. data, Basu (1997) finds results consistent with his predictions.
3.3.3 Earnings measures

Conservatism implies that gains tend to be more persistent than losses, because financial statements do not recognize unverifiable increases in asset values (gains) at the time they occur, but over future periods as the cash flows generating those increases are realized. For example, if an asset’s value increases because it is expected to throw off more future cash flows, then the gain is recognized over the future years as the increased cash flows come in. This means that gains tend to be persistent. Since firms with positive earnings or earnings changes are likely to have recognized gains, positive earnings and earnings increases are also likely to be persistent.

Losses of the same degree of verifiability as the unverifiable gains tend to be recognized as they occur rather than in the future as the cash flow decreases are realized there is a lump sum drop in earnings at the time of the loss rather than a flow of reduced earnings in the future. Firms with negative or decreasing earnings are more likely to have recognized losses. Since, on average, these losses do not recur in future periods, negative earnings and earnings decreases are less likely to persist than positive earnings and earnings increases. Because those negative earnings and earnings decreases are transitory, the persistence or transience of earnings and earnings changes provides measures of conservatism (Watts, 2003).

Basu (1997) provides evidence that negative earnings changes are more likely to reverse than positive earnings changes. Basu (1997) regresses earnings changes, on lagged earnings changes for samples of positive and negative earnings changes. The estimated lagged earnings coefficient for positive earnings changes is insignificantly different from zero, consistent with positive earnings changes being permanent and not reversing. In contrast, the estimated lagged earnings coefficient for negative earnings changes is significantly negative, but is not significantly different from one, the value expected when negative earnings changes are completely transitory.

Givoly and Hayn (2000) argue that if conservatism leads to an immediate and complete recognition of negative events and a delayed and gradual recognition of positive events, it is likely to result in a negatively skewed earnings distribution. Second, to the extent that increased conservatism takes the form of either a more immediate (rather than gradual) recognition of bad news, or a greater tendency to provide for anticipated future costs or losses, such an increase will be associated with increased variability of the earnings series. Accordingly, two additional measures of conservatism are the skewness and variability of the earnings distribution. Givoly and Hayn (2000) find that the distribution of return on assets, whether derived from time-series of individual firms or the cross-section of firm-years, is negatively skewed for most of the periods.
they examine. They report a significant increase in firms reporting losses and a decline in the accounting rate of return (return on assets) from the 1950s to the 1990s, with the increased skewness indicating an increase in conservatism over time.

3.3.4 Accrual Measures

Conservatism’s asymmetrical treatment of gains and losses produces an asymmetry in accruals. Because losses tend to be fully accrued while gains are not, periodic accruals tend to be negative and cumulative accruals tend to be understated. As a result, negative periodic net accruals and negative cumulative accruals accumulated over periods can be used as measures of conservatism. In addition, conservatism suggests that losses, which effectively capitalize reductions in future cash flows, generate more very large accruals than gains, which reflect only the cash flow increase in the period it occurs. For this reason, one predicts negatively skewed distributions of accruals and earnings and suggests that estimates of the negative skewness of distributions of earnings, earnings changes, and accruals are measures of conservatism (Watts, 2003)

Givoly and Hayn (2000) report a significant increase in firms reporting losses and a decline in the accounting rate of return (return on assets). In contrast to earnings, there is no increase in the incidence of negative cash flows nor is there a decrease in the CFO-to-assets ratio over the 48-year period examined. These results strongly suggest that the decline in profitability found in the US of the period that is examined is not a result of a change in the distribution of the underlying cash flows, but rather stems from a change in the relation between cash flows and earnings, that is, a change in accounting accruals. For firms in a steady state with no growth and neutral accounting, earnings converge to cash flows and periodic accruals converge to zero. A consistent predominance of negative accruals across firms over a long period is an indication of conservatism. Their results show an almost continuous accumulation of negative accruals since the 1980s. Not only is net income before depreciation systematically and consistently below cash flows from operations, the pace of accumulation accruals is accelerating in the later periods, indicating a shift in the degree of conservatism over time. The results by Givoly and Hayn (2000) highlight the importance of accruals for accounting conservatism.

An important role of accrual accounting in conservative accounting is the use of accruals for the timely recognition of unrealized gains and losses. This is due to revisions in the current-period cash flow from a durable asset being positively correlated with current-period revisions in its expected future cash flows. For example, a plant with decreased current-period cash flow due to becoming uncompetitive most likely faces a downward revision in its expected future cash flows as well. Timely recognition of the impaired future cash flows requires an income-
decreasing accrual (Ball and Shivakumar, 2006). Implication of the gain and loss recognition role of accruals is that other things equal (notably, exogenous working capital changes) accruals are positively correlated with current-period operating cash flows. This role of accruals is the opposite of the Dechow (1994) noise reduction role of accruals, even though both roles serve to increase financial reporting quality. For example, timely gain and loss recognition induces positive correlation between accruals and current-period operating cash flow, but noise mitigation induces negative; and one increases earnings volatile relative to cash flows, but the other decreases it. Discriminating between the two roles of accruals can be quite challenging, because earnings only exhibit the net effect of two offsetting processes.

Ball and Shivakumar (2006) show that conditional conservatism introduces an asymmetry in the relation between accruals and cash flow. Economic losses are more likely to be recognized on a timely basis, as accrued (i.e., non-cash) charges against income, whereas economic gains are more likely to await recognition until realized in cash. This asymmetry holds for both working capital accruals (e.g., the lower-of-cost-or-market rule for inventories requires income-decreasing but not income-increasing accruals) and longer cycle accruals (e.g., impairing but not revaluing property, plant and equipment, or goodwill). It implies that the positive correlation between cash flows and accruals arising from the timely recognition role of accruals is greater in periods with economic losses than in periods with economic gains. In turn, this implies that accruals models that are linear in cash flows are mis-specified, and that the correct specification most likely is piecewise linear. No such asymmetry is predicted by the noise reduction role of accruals.

Ball and Shivakumar (2005) show that there is a difference in the use of accruals for timely loss recognition between private companies and public companies. Private companies face a lower demand for reporting quality, as information asymmetry is more likely to be solved by insider access to performance information. They show that timely loss recognition is substantially less prevalent in private companies than in public companies. This result reinforces the estimation by Dechow and Dichev (2002), who argue and subsequently show that accrual quality will be systematically related to firm and industry characteristics.

Accounting, and thus the accrual adjustments made by firms, is fundamentally linked to underlying economics. A firm that is raising capital and growing will also be a firm that is recording large positive accruals relative to assets. In contrast a firm that is declining or

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16 Other implications of the gain and loss recognition role of accruals are that, other things equal (notably, noise-reducing working capital accruals): earnings changes are more negatively serially correlated than cash flows, because they incorporate transitory accrued losses; earnings are more volatile than cash flows; and earnings are more highly correlated with stock returns (Basu, 1997).
downsizing will be recording large negative accruals relative to assets. The philosophy behind the accounting rules that apply to growing and declining firms differ fundamentally and this difference likely stems from the historical emphasis on reliability and conservatism in accounting. It seems possible that the difference in timely loss recognition between private firms and public firms is driven by differences in the underlying economics of the firm in which these two companies operate. Dechow and Ge (2006) point out that the difference in accounting perspective for accruals is likely to be dependent on the life cycle the company is in. Young, growing firms are typically reporting large positive accruals (also likely abnormal accruals). These firms are purchasing assets, generating sales, and expanding their businesses. Accrual accounting generally does not attempt to fair-value these growth opportunities on the balance sheet. Growing firms only record assets that meet certain criteria and these assets are generally recorded at capitalized cost. Accrual accounting for high accrual firms tends to have an income statement perspective, focusing on revenue recognition and matching costs that generate the revenue.

In contrast, when firms are downsizing, the accounting rules have a strong balance sheet perspective. As a firm exits lines of businesses, assets such as inventory, goodwill, property, plant, and equipment are likely to have market values less than their book values. In such circumstances, assets are typically written down to their fair value. Marking assets and liabilities to fair value results in changes in value being reflected in earnings. These accrual adjustments result in impairment charges, restructuring charges, and other special items being recorded in the income statement. This reflects the role of accruals in timely loss recognition.17

3.4 Summary and implications for this study

In this chapter, the role of accruals for accounting conservatism is discussed. Accounting conservatism does not have a specific definition, and is therefore implemented in various ways. One of the ways conservatism is implemented is through the use of accruals. More specifically, one of the roles of accounting accruals is the timely recognition of unrealized losses.

Accounting conservatism implies the exercise of caution in the recognition and measurement of income and assets. Two forms of accounting conservatism have emerged in the literature. One is an accounting bias toward reporting low book values of stockholder equity. This

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17 This is also likely to affect the persistence of earnings, as well as the differential persistence of cash flows and accruals. As pointed out by Schipper and Vincent (2003), the more assets and liabilities that accounting rules mark to fair value, the more likely it is that earnings reflects changes in fair value, and so the lower the persistence of earnings. In contrast, cash flows are not affected by these accounting rules.
kind of conservatism is called ex ante conservatism, also called news-independent conservatism and unconditional conservatism (Beaver and Ryan, 2005). The second form of conservatism is the asymmetric timeliness of loss recognition. Timeliness of loss recognition is a summary indicator of the speed with which adverse changes in the expectation of future cash flows are reflected in both income statements and balance sheets. This second kind of earnings conservatism is called ex post conservatism, news-dependent conservatism and conditional conservatism (Beaver and Ryan, 2005).

Several empirical measures have been used to gauge the degree of accounting conservatism. In general, researchers use four types of measures to assess conservatism: (1) net asset measures (e.g. book-to-market ratio); (2) earnings/stock returns relation measures (e.g. the explanatory power of a regression of stock prices on earnings changes); (3) earnings measures (e.g. the earnings distribution); (4) accrual measures.

One of the accrual measures is the use of accruals for conditional conservatism, or timely loss recognition (Ball and Shivakumar, 2006). Accruals reflect managerial discretion in showing a revision in expected future cash flows in current earnings. This has resulted in a high amount of firms reporting overall net losses. However, since investors react differently to net losses than to net profits (Hayn, 1995), it remains a empirical question if the incentive for profit firms to effect conditional conservatism through accruals is similar to the incentive for conditional conservatism for loss firms. In chapter 8, I examine differences in conditional conservatism, or timely loss recognition, between profit firms and loss firms. I expect conditional conservatism through accruals to be more relevant for loss firms than for profit firms.

Timely loss recognition is one measure of earnings quality (Ball and Shivakumar, 2005). In the next chapter, I further discuss the role of accruals in earnings quality. In chapter 5, I discuss the role of accruals for firms with low earnings quality, i.e. firms that engage in earnings management.