

The Pricing of Conservative Accounting and the Measurement of Conservatism at the Firm-Year Level

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Abstract

This paper analyzes the pricing of conservative accounting and introduces a new measure of conservatism. We contribute to the conservatism literature in two main ways. First, we analyze the nonlinear pricing of conservatism using the return decomposition model of Vuolteenaho (2002) and investigate the pricing implications of special items which are one of the main accrual items through which conservatism is facilitated. Our conceptual analysis implies – and our empirical results show - that the asymmetric properties of conservative accounting and the existence of alternative non-accounting sources of information generate a nonlinear relation between the unexpected revision in equity returns and earnings news, which is defined as the shock to current and future cash flows. Underlying this nonlinearity pricing result is the assumption that equity markets learn about shocks to firm cash flows from non-accounting as well as accounting sources. In addition, the analysis implies that the GAAP treatment of special items generates a nonlinear and discontinuous relation between unexpected revisions in equity returns and special items. Second, based on this model, we construct a conservatism ratio (CR) at the *firm-year* level that is a function of *contemporaneous* good/bad news. CR is defined as the ratio of the current earnings shock to total earnings news and measures how much of the total shock to expected future earnings is recognized in current year earnings. We show empirically that CR incorporates bad news faster than good news at the firm and year level, consistent with conservative accounting.