Accounting Conservatism and Income-Increasing Earnings Management

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ABSTRACT

We examine the relation between earnings management to meet or barely beat analyst forecasts and the cross-sectional variation in contemporaneous and past accounting conservatism. Investigating the link between earnings management and accounting conservatism is important because doing so provides evidence concerning conservatism's ability to constrain managers' opportunistic behavior. We first estimate a modified version of the Basu (1997) model and find a negative relation between contemporaneous conditional conservatism and earnings management to avoid a negative earnings surprise. In contrast, we find a positive relation between past unconditional conservatism and earnings management to avoid a negative earnings surprise. Taken together, our results suggest that unconditional conservative accounting generates slack that, in the presence of bad news, allows managers to avoid writing down net asset values and thus increases firms' likelihood of meeting or beating analyst forecasts.

The Relation Between Accounting Conservatism and Income-increasing Earnings Management

1. Introduction

This research examines the link between cross-sectional differences in accounting conservatism and earnings management. We first investigate whether firms that have zero or slightly positive earnings surprises *contemporaneously* incorporate bad news into earnings slower than firms that have slightly negative earnings surprises. Next, we investigate whether firms that have zero or slightly positive earnings surprises are more conservative in *prior years* than firms that have slightly negative earnings surprises. Finally, we follow Qiang (2007) and separate past accounting conservatism into conditional and unconditional dimensions and investigate the extent to which these two dimensions of conservatism are related to subsequent years' earnings management activity.

Conservatism exists primarily to constrain managers' opportunistic behavior and thus protect bondholders, shareholders, and firms' other stakeholders, i.e. helps reduce contracting costs (Watts 2003a and b). Surprisingly, given this role of accounting conservatism and its increase over time (Givoly and Hayn 2000), earnings management continues to be regarded as "both pervasive and problematic (Dechow and Skinner 2000). Our research addresses this paradox and provides evidence on whether the application of conservative accounting is consistent with firms meeting or slightly beating analyst forecasts, a proxy for earnings management behavior.

Beaver and Ryan's (2005) classification of accounting conservatism into two dimensions, conditional and unconditional conservatism, provides key insights that help resolve this paradox. Conditional conservatism, which is the extent to which a firm writes down its net assets in the presence of bad news but does not write up net assets in the presence of bad news, helps

constrains managers' opportunistic behavior. Unconditional conservatism captures the understatement of the net book value of assets as a result of the normal accounting process. Qiang (2007) argues that contracting cost considerations only lead to conditional conservatism because unconditional conservatism "does not utilize new information" (Basu 1997) and, due to added noise in payoffs to contracting parties, "could reduce contracting efficiency." Moreover, Beaver and Ryan (2005) argue that unconditional conservatism creates accounting slack that actually prevents the future application of conditional conservatism unless the news is sufficiently bad that the slack is used up. All else equal, because firm-years with more beginning accounting slack will be able to avoid net asset writedowns in the presence of bad news, consistent with conservative accounting we expect firm-years with zero or slightly positive earnings surprises to reflect lower contemporaneous conditional conservatism and higher past unconditional conservatism than firm-years with slightly negative earnings surprises.

Our research is motivated in part by the statement in Beaver and Ryan (2005, 302) that "…discretionary behavior regarding conditional and unconditional conservatism is fertile ground for future research." Our research is closely related to Barton and Simko (2002). They link higher beginning net operating assets, which they argue measures past accounting aggressive discretionary behavior, to firms' likelihood of meeting or barely beating analysts' forecasts. Although net operating assets can be interpreted as a measure of accounting conservatism, it does not distinguish between conditional and unconditional conservatism. We distinguish between these dimensions of conservatism and provide evidence concerning the distinct roles that past conditional and unconditional conservatism play in helping explain why some firms are unable to meet earnings targets despite the adverse capital market effects from failing to do so (e.g., Barth et al. 1999 and Bartov et al. 2002).

In our first set of tests, we measure contemporaneous conditional accounting conservatism using the Basu (1997) model, which, in a reverse regression of earnings on returns, allows for the earnings-return relation to differ between good news (overall positive returns) and bad news (overall negative returns) firms. Basu (1997) interprets a greater return response coefficient for bad news firms as evidence of accounting conservatism; i.e., firms incorporate bad news into their financial statements more quickly than they incorporate good news. We separately estimate the Basu (1997) model for subsamples of firm-years that meet or barely beat the most recent analyst forecast versus firm-years that barely miss this earnings target. We expect that the bad news firm-years that meet or barely beat the latest earnings forecast have a lower incremental return response coefficient than bad news firm-years that miss this earnings target, consistent with earnings management that defers recognition of bad news into earnings and thus exhibiting lower conditional conservatism. Our results are consistent with this expectation and suggest that firm-years with a zero or slightly positive earnings surprise contemporaneously engage in less conditional conservative accounting practices than firm-years that have a slightly negative earnings surprise.

Next, using both the Beaver and Ryan (2000) market-based and Givoly and Hayn (2000) accruals-based conservatism metrics as empirical surrogates for past conservatism, we classify firm-years in the top (bottom) one-third of the past conservatism distribution as having high (low) past (unconditional) conservatisms. Consistent with the theoretical predictions of the Beaver and Ryan (2005) model, we expect that in the presence of bad news (overall negative stock returns) firm-years with higher past conservatism are more likely to meet or barely beat earnings benchmarks than firm-years with low past conservatism. Our results are consistent with this expectation. Next, we decompose past accounting conservatism into its conditional and

unconditional components following (Qiang 2007) and repeat this analysis. Our results are consistent with higher prior years' unconditional conservatism that creates accounting slack, allowing firms to avoid negative earnings surprises, but inconsistent with prior years' opportunistic behavior that creates "cookie jar reserves" via higher conditional conservatism.

Our evidence contributes to both the accounting conservatism and earnings management literature. We extend Barton and Simko (2002) by decomposing past conservatism into its conditional and unconditional components. We also add to recent research that documents the existence and prevalence of conservatism in accounting practices (e.g., Basu 1997; Ball et al. 2000; Givoly and Hayn 2000; Beaver and Ryan 2000; Ahmed et al. 2002; Penman and Zhang 2002). Accrual-based metrics (e.g., Dechow et al. 1995) and deferred tax expense (Phillips et al. 2003) have been linked to earnings management. We link contemporaneous conditional and lagged unconditional, but not conditional, conservatism metrics to income-increasing earnings management. These results are consistent with accounting conservatism that on one hand constrains managers' opportunistic behavior in past years yet facilitates avoiding negative earnings surprises in subsequent years. Finally, our results are consistent with the Beaver and Ryan (2005) model predictions and thus support the theoretical development of conditional and unconditional conservatism.

Our paper proceeds as follows. Section 2 discusses prior literature and develops hypotheses. Section 3 presents the research design. Section 4 describes the sample and data, and Section 5 presents the results. Section 6 provides the conclusion.

2. Background and Hypothesis Development

2.1. Income-increasing earnings management

Our study examines the relation between cross-sectional differences in accounting conservatism and income-increasing earnings management. Managers have strong incentives to mjanage earnings to avoid missing analysts' forecasts. Bartov et al. (2002) find that, regardless of absolute performance, the market rewards firms for simply meeting or beating analysts' forecasts and penalizes them for failing to do so. Kasznik and McNichols (1999) find a market valuation premium associated with meeting or beating analysts' forecasts. Similarly, Lopez and Rees (2000) find that firms meeting or beating analysts' forecasts have higher earnings response coefficients than firms that do not meet analysts' earnings expectations. Accordingly, we operationalize earnings management based on whether firm-years meet or slightly beat analysts' earnings forecasts.

Consistent with incentives to avoid negative earnings surprises recent studies (e.g., Degeorge et al. 1999; and Myers et al. 2005) rely mainly on discontinuities in the earnings surprise and earnings change distributions and document pervasive income-increasing earnings management to meet or beat analysts' forecasts. Durtschi and Easton (2005), however, argue that the discontinuity in the earnings surprise distribution results from sample selection criteria relating to firms contained in the I/B/E/S database. Accordingly, in sensitivity analyses we follow Matsumoto (2002) and classify all firm-years that meet or beat analyst forecasts as earnings managers.

2.2. Accounting Conservatism

Watts (2003a, 208) defines conservatism as the "asymmetrical verification requirements for gains and losses" and argues that "[c]onservatism constrains managerial opportunistic behavior and offsets managerial biases [to inflate earnings] with its asymmetrical verification requirement" (Watts 2003a, 209).

2.3. H1 – Contemporaneous Conditional Conservatism and Earnings Management

Beaver and Ryan (2005) define conditional conservatism as the practice of writing down net assets in the presence of bad news (e.g., recording an asset impairment charge when the firm's asset value is permanently impaired) but never writing up net assets when the firm receives favorable news (e.g., the firm is awarded a highly-profitable long-term contract). The application of conditional conservatism biases earnings downward and is thus a mechanism that potentially mitigates income-increasing earnings management. There is evidence, however, that firms vary in their levels of conservatism. For example, Beaver and Ryan (2000) and Ahmed et al. (2002) both document cross-sectional differences in conservatism. Furthermore, in their call for research regarding discretionary behavior and conditional conservatism, Beaver and Ryan (2005) implicitly recognize the possibility that conditional conservatism could vary with earnings management activity.

Based on the above discussion, our first hypothesis, stated in the alternative, is

H1: Firm-years that meet or slightly beat analysts' earnings forecasts are conditionally less conservative than firm-years that miss this earnings target.

2.4. H2 –Past (Unconditional) Conservatism and Earnings Management

Beaver and Ryan (2005) define unconditional conservatism as the understatement of the net book value of assets as a result of the normal accounting process. Beaver and Ryan (2005) argue that unconditional conservatism creates accounting slack that allows managers to avoid writing down net asset values (i.e., the application of conditional conservatism) unless the news is so bad that all the accounting slack is used up. Similarly, Barton and Simko (2002) find that managers' abilities to opportunistically increase earnings is limited by the extent to which the balance sheet has overstated net operating assets relative to a neutral application of GAAP. The

Barton and Simko (2002) net operating assets measure, however, captures total accounting conservatism, whereas the Beaver and Ryan (2005) theory only links past unconditional conservatism to future conditional conservatism. We thus extend Barton and Simko (2002) and separately investigate the link between past unconditional accounting conservatism and managers' abilities to avoid negative earnings surprises. We investigate this link by testing the following hypothesis, stated in the alternative:

> H2a: In the presence of bad news, firm-years that were more unconditionally conservative in prior years are more likely to meet or beat analysts' earnings forecasts than firm-years that were less unconditionally conservative in prior years.

We make no prediction concerning the link between past conditional conservatism and earnings management to avoid a negative earnings surprise for two reasons. First, the Beaver and Ryan (2005) theoretical prediction only involves the relation between unconditional, and not conditional, conservatism. Second, evidence linking greater monitoring and corporate governance to higher conservatism (e.g. Ahmed and Duellman 2007) implies that the consistent application of conditional conservatism would not allow managers to vary their levels of conditional conservative in such a way as to create "cookie jar reserves" that can be used to manage future earnings.

3. Research Design

3.1 Contemporaneous (Conditional) Conservatism and Earnings Management

Basu (1997) estimates the following equation to investigate accounting conservatism:[1]

$$EPS_{it} / P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 DR_{it} + \beta_3 R_{it} * DR_{it} + \varepsilon_{it} \quad (1)$$

[1] Basu (1997) also estimates equation (1) using two other returns measures. First, he calculates the return for firm i for the period beginning nine months before fiscal year-end t through three months after fiscal year-end t. We do not use this returns measure because it would include the earnings announcement period. He also estimates the relation between market-adjusted returns and mean-adjusted scaled earnings per share. We do not use these earnings and returns measures because we believe unadjusted earnings and returns captures conservatism associated with both market-wide and firm-specific bad news, which we believe best measures the conservatism construct.

where

EPS_{it} = earnings per share of firm *i* in fiscal year *t* (EPSPX #58);

P_{it-1} = the price per share of firm *i* at the beginning of the fiscal year *t*; (PRCCF #199);

R_{it} = the cumulative return of firm *i* during fiscal year *t* ;

DR_{it} = an indicator variable set equal to 1 if R_{it} is negative and 0 otherwise; and

ε_{it} = the error term.

Basu (1997) finds that β_3, the coefficient on $R_{it} * DR_{it}$, is significantly positive, consistent with bad news being incorporated into earnings faster than good news, a result that supports his conservatism hypothesis.

Our first set of tests investigates whether firms that meet or beat earnings benchmarks contemporaneously engage in less conservative accounting practices than firms that miss this earnings target. We estimate the following modified Basu (1997) model:

$$EPS_{it}/P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 DR_{it} + \beta_3 R_{it} * DR_{it} + \beta_4 EM_{it} + \beta_5 EM_{it} * R_{it}$$

$$+ \beta_6 EM_{it} * DR_{it} + \beta_7 EM_{it} * R_{it} * DR_{it} + \varepsilon_{it} \qquad (2)$$

where EM_{it} = 1 if firm *i* meets or beats the earnings benchmark in year *t* and all other variables are as previously defined. For H1a, we follow prior research (e.g., Brown 2001; Bartov et al. 2002; and Brown and Caylor 2005) and use the most recent forecast prior to the earnings announcement to compute the earnings surprise (IBES actual earnings per share – IBES most recent analyst forecast). We follow Matsumoto (2002) and define EM_a as 1 if the analyst earnings surprise ≥ 0 and EM_a as 0 if the earnings surprise is < 0.[2] To test H1b, whether firms that meet or beat last year's earnings are less conservative than firms that barely miss this target, we define EM_b as 1 if the change in firm *i*'s net income per share from year *t-1* to *t* (NI_t #172-

[2] In our robustness tests involving meeting or beating analyst forecasts, we follow Dhaliwal et al. (2004) and define EM_a as 1 if the analyst earnings surprise ≥ 0 and < 0.05 (five cents) and EM_a as 0 if the earnings surprise is ≥ -0.05 and < 0.

NI_{t_1})/($CSHO_{t\_2}$ #25 * $PRCCF_{t\_2}$ #199) is $\geq$ 0 and EM_b as 0 if the change in net income per share is < 0.[3]

Our modified Basu (1997) specification allows us to assess how firms vary their levels of conditional accounting conservatism. The coefficient on $EM_{it} * R_{it} * DR_{it}$, β_7, which is estimated for the sample of firms that meet or beat the earnings target and have bad news (EM_{it} = 1, DR_{it} = 1), represents the incremental return response coefficient for these firms. A negative β_7 would suggest that earnings management firms delay recognition of bad news into earnings to beat an earnings benchmark. Consistent with H1a and H1b, we expect β_7 to be negative.

3.*2 Past (Unconditional) Conservatism and Earnings Management*

Our next set of tests investigates whether past accounting conservatism (measured during years *t-6* through *t-1*) is related to current year earnings management (observed in year *t*); i.e., whether in the presence of bad news firms that engaged in more (less) conservative accounting practices in prior years are more (less) likely to meet or beat earnings benchmarks. Accordingly, we estimate the following pooled cross-sectional equation using probit regression to link past conservatism to the probability that a firm-year is classified as an earnings-management firm-year:

$$EM_{it} = \alpha + \gamma_1 PC_{it} + \gamma_2 DR_{it} + \gamma_3 PC_{it} * DR_{it} + \gamma_4 CFO_{it} + \varepsilon_{it} \quad (3)$$

where

EM_{it} = 1 if the firm is in the earnings management group, and 0 otherwise;

[3] In our robustness tests involving meeting or beating prior year's earnings, we follow Burgstahler and Dichev (1997) and Phillips et al. (2003) and define EM_b as 1 if the change in firm *i*'s net income (NI #172) from year *t-1* to *t* divided by the market value of equity at the end of year *t-2* (CSHO #25 × PRCCF #199) is $\geq$ 0 and < 0.01, and EM_b as 0 if the change in net income $\geq$ -0.01 and < 0. Burgstahler and Dichev (1997) use three scaled earnings change intervals (0-0.005, 0-0.01, 0-0.015). We follow Phillips et al. (2003) and use the middle interval to perform our empirical analysis.

PC_{it} = 1 if the firm-specific past conservatism metric is in the top third of the distribution, and 0 if it is in the bottom third of the distribution;

CFO_{it} = cash flows from operations per share ((OANCF #308 – XIDOC #124)/CSHO #25) in H2a, and the change in cash flows from operations (Δ(OANCF #308 – XIDOC #124)/CSHO #25) in H2b.

and other variables are as previously defined. Estimating equation (3) allows us to link current year earnings management (EM_{it}) to prior years' (unconditional) accounting conservatism.

PC_{it} is a dichotomous variable based on the Beaver and Ryan (2000) model and is used to proxy for the extent to which a firm has engaged in conservative accounting practices in prior years. Because of measurement error inherent in this firm-specific conservatism measure, we set PC_{it} equal to one (zero) if this measure is in the top (bottom) third of the distribution and delete observations in the middle one-third of the distribution.[4] DR_{it}, an indicator variable equal to one when the firm-year has negative stock returns and zero otherwise, is our proxy for bad news. To test H2a and H2b, we interact the past (unconditional) conservatism measure with the bad news indicator variable. We expect $PC_{it}*DR_{it}$ to have a positive coefficient in the presence of earnings management to avoid a negative earnings surprise/change; i.e., higher past (unconditional) conservatism makes it more likely that a firm can avoid writing down net assets, and thus meet or beat an earnings benchmark, in the presence of bad news.

We include CFO_{it} (ΔCFO_{it}) when EM_a (EM_b) is the dependent variable to measure firm performance and expect this variable to be positively related to meeting or beating the respective earnings targets.

Our measure of accounting conservatism, PC_{it}, is based on Beaver and Ryan's (2000) market-based conservatism parameter, $-\alpha_i$, which is estimated in the following model:

[4] The Beaver and Ryan (2000) market-based measure only provides an annual ranking of firms' prior conservatism, making this measure incomparable across years. We are more confident that firms ranked in the top (bottom) one-third of each annual distribution have high (low) past accounting conservatism.

$$BTM_{it} = \alpha + \alpha_i + \alpha_t + \sum_{k=0}^{6} \beta_k RET_{i,t-k} + e_{it} \quad (4)$$

where

BTM_{it}	=	the book-to-market ratio for firm i at fiscal year-end t ((CEQL #235/CSHO #25) / PRCCF #199);
α	=	the intercept across all firms and years;
α_i	=	the firm-specific component of *BTM* over the period (conservatism);
α_t	=	the year-specific component of *BTM* across all firms;
$RET_{i,t-k}$	=	the stock return for firm *i* in fiscal year *t-k*;

Estimating equation (4) extracts the conservatism bias (α_i), in addition to the effects of the firm's current and lagged returns (RET_{it-k}) and average time effects (α_t) across all firms. As a component of the book-to-market ratio, α_i measures conservatism inversely. A lower α_i implies that a firm is more conservative, i.e., the more book value is biased downward. By construction, α_i is a measure of relative conservatism and not aggregate conservatism and is used to proxy for the extent to which conservatism varies across firms (Ahmed et al. 2002). We multiply α_i by –1 to create PC_{it}, a firm-specific measure for which higher (lower) values represent greater (lesser) accounting conservatism in prior years.

Although prior research (e.g., Ahmed et al. 2002) has used both the Beaver and Ryan (2000) market-based and Givoly and Hayn (2000) accrual-based measures of firm-specific conservatism, we use the former measure in our primary empirical tests for the following reasons.[5] First, the Beaver and Ryan (2000) model arguably captures and is more consistent with the definition of unconditional conservatism - the general understatement of assets as a result of applying conservative accounting practices. Second, similar to the Beaver and Ryan (2000)

[5] The inferences based on the H2a and H2b test results reported in Table 4 do not change when we use the Givoly and Hayn (2000) measure to proxy for past (unconditional) conservatism.

model, recent research (e.g., Roychowdhury and Watts 2006) has focused on the relation between the market-to-book ratio and conditional conservatism. Finally, the Beaver and Ryan (2000) measure is being used in current research as a proxy for unconditional conservatism (e.g., Balachandran and Mohanran 2006).

3.3 Linking Earnings Management to Both Contemporaneous (Conditional) and Past (Unconditional) Conservatism

In our third set of tests, we link earnings management activity to both contemporaneous (conditional) and past (unconditional) conservatism. Our first set of hypotheses (H1a and H1b) predict that firm-years that meet or beat earnings benchmarks (EM_{it} = 1) are conditionally less conservative than firm-years that fail to meet these benchmarks (EM_{it} = 0). The Beaver and Ryan (2005) model, which underlies our second set of hypotheses (H2a and H2b) predicts that firm-years with low past (unconditional) conservatism (PC_{it} = 0) should have, in the presence of bad news, higher conditional conservatism than firm-years with high past (unconditional) conservatism (PC_{it} = 1). Taken together, these predictions lead to the expectation that firm-years that fail to meet earnings benchmarks and have low past (unconditional) conservatism (EM_{it} = 0 and PC_{it} = 0) should reflect the highest conditional conservatism. Conversely, firm-years that meet or beat earnings benchmarks and have high past (unconditional) conservatism (EM_{it} = 1 and PC_{it} = 1) should reflect the lowest conditional conservatism.

To test this prediction, we estimate the Basu (1997) model, equation (1), for the following sub-samples: (1) firm-years with EM_{it} = 0 and PC_{it} = 0, (2) firm-years with EM_{it} = 0 and PC_{it} = 1, (3) firm-years with EM_{it} = 1 and PC_{it} = 0, and (4) firm-years with EM_{it} = 1 and PC_{it} = 1. We expect the return response coefficient for bad news firms, β_3, to be the highest in the sub-sample in which EM_{it} = 0 <u>and</u> PC_{it} = 0 and the lowest in the sub-sample in which EM_{it} = 1

and PC_{it} = 1. We make no prediction regarding the relative magnitudes of the β_3 estimates in the sub-sample in which EM_{it} = 0 and PC_{it} = 1 versus the sub-sample in which EM_{it} = 1 and PC_{it} = 0.

4. Data and Samples

As reported in Table 1, Panel A, we begin with 31,856 and 56,299 firm-years of domestic, publicly traded firms with the necessary data for our analyses investigating the contemporaneous relation between conditional accounting conservatism and earnings management to avoid a negative earnings surprise and to avoid a negative earnings change, H1a and H1b, respectively. In our earnings surprise (earnings change) tests, we delete 574 (1,552) firm-years having EPS_{it}, scaled by per share price at the beginning of year t, or R_{it} below the 1st percentile or above the 99th percentile to control for extreme observations. We also delete 1,955 (3,261) firm-years in our earnings surprise (earnings change) analyses in which R_{it} is not in the interval (-1, 1).[6] These procedures result in test samples of 29,327 and 51,486 firm-years in our tests of H1a and H1b, respectively.

Next, in Table 1, Panel B, we turn to our analyses involving the relation between past (unconditional) accounting conservatism and earnings management to meet or beat earnings targets (H2a and H2b). We estimate equation (3) to investigate the relation between earnings management and past conservatism using the Beaver and Ryan (2000) market-based measure, PC_{it}, which is calculated over the prior six years. Further, because data necessary to compute PC_{it} requires six years lagged returns for each year of the six years included in the panel data conservatism estimation model (a total of 12 years), this conservatism measure cannot be

[6] Dietrich et al. (2004) criticize the Basu (1997) model because the partitioning variable, returns, has greater variance for positive returns, which are unbounded, than for negative returns, which are bounded at -1. Dietrich et al. (2004) show that this differential in variance produces an upward bias in the coefficient on returns for the bad news (i.e., negative return) firms. Restricting returns to be in the interval (-1,1) helps correct for this bias. In robustness checks of our H1a and H1b results, we re-estimate equation (2) without restricting returns (R_{it}) to be in the interval (-1, 1). Inferences from these results are consistent with those reported in Table 3.

computed until the period 1991 to 1996, resulting in the first lagged conservatism measure for 1997. We thus have only 10,091 firm-years for our analyses.

Next, we delete the middle one-third of the annual conservatism distribution and classify the top (bottom) one-third of each distribution as high (low) prior unconditional conservatism firm-years. This selection process results in 6,771 firm-years. In the tests of H2a and H2b, earnings management to avoid a negative earnings surprise and to avoid a negative earnings change, we delete 3,916 and 2,441 firm-years, respectively, without data to compute the remaining variables. Finally, we delete 155 and 242 firm-years in our H2a and H2b tests to remove extreme observations, resulting in test samples of 2,700 and 4,088 firm-years, respectively.

5. Results

5.1 Descriptive Statistics

Descriptive statistics for variables included in equation (2), the modified Basu (1997) model, are reported in Table 2, Panels A, and B. In Panel A, we report descriptive statistics relating to our tests of earnings management to avoid a negative earnings surprise for the EM_a = 1 and EM_a = 0 subsamples. Not surprisingly, the means and medians for both EPS_{it} / P_{it-1} and R_{it} are significantly greater for the EM_a = 1 versus EM_a = 0 firm-years. In Table 2, Panel B, we report descriptive statistics relating to our tests of earnings management to avoid an earnings decline. Again, the EM_b = 1 firm-year means and medians for both EPS_{it} / P_{it-1} and R_{it} are significantly greater than those for the EM_b = 0 firm-years.

Descriptive statistics for variables included in equation (3) and the additional tests linking earnings management activity to both contemporaneous (conditional) and past (unconditional) conservatism are reported in Table 2, Panels C and D. As expected, the means and medians

reported in Panel C for the scaled earnings per share, stock returns and cash flow variables are all significantly greater in the $EM_a = 1$ versus $EM_a = 0$ sub-samples in which firm-years either meet or beat or miss the latest analyst forecast. The same results hold when EM_b is the dependent variable and the earnings target is prior year's earnings, as reported in Panel D.

5.2 H1a and H1b – The Relation between Differences in Contemporaneous (Conditional) Conservatism and Earnings Management to Meet or Beat Earnings Targets

We report the results of investigating the association between cross-sectional differences in contemporaneous (conditional) accounting conservatism and whether firms manage earnings to avoid missing an earnings benchmark in Table 3. Panel A presents the results of estimating equations (1) and (2) to examine the association between contemporaneous (conditional) accounting conservatism and earnings management to avoid a negative earnings surprise. The first column reflects the results of estimating the Basu (1997) model, equation (1), for the full sample. The coefficient on $R_{it} * DR_{it}$ is significantly positive, consistent with Basu's (1997) findings, and is interpreted as evidence of accounting conservatism; i.e., the association between earnings and returns is stronger for bad news firms than that for good news firms.

The second (third) column reports results of estimating the Basu (1997) model for EM_a = 1 (EM_a = 0) firm-years. These results indicate that coefficient on the interaction term $R_{it} * DR_{it}$ is lower for the EM_a = 1 sub-sample than for the EM_a = 0 sub-sample. These results suggest stronger relation between earnings and returns in the presence of bad news, and thus greater contemporaneous (conditional) accounting conservatism, for firms that have negative earnings surprises versus firms that meet or beat analysts' earnings expectations.

The pooled results reported in the fourth column of Table 3, Panel A, facilitate a statistical test of the difference in the firms' return response coefficients. Consistent with H1a, the coefficient on the interaction term $EM_{it} * R_{it} * DR_{it}$ is significantly negative (-0.044; p =

0.002), suggesting that firms that avoid a negative earnings surprise are contemporaneously (conditionally) less conservative, i.e., engage in less conservative accounting practices, than firms that barely miss this earnings benchmark. Specifically, the $EM_a = 1$ firm-years delay recognition of bad news into earnings, relative to the $EM_a = 0$ firm-years, to achieve this benchmark.

In Table 3, Panel B, we report the results of investigating the association between cross-sectional differences in contemporaneous (conditional) accounting conservatism and whether firms manage earnings to avoid negative earnings change. The last column reports the results of estimating the modified Basu (1997) model, equation (2). The coefficient on $EM_{it} * R_{it} * DR_{it}$ is -0.028 and significant (p = 0.050). This result is consistent with the firm-years that meet or beat last year's earnings delaying recognition of bad news relative to those firms that miss this earnings target. This evidence suggests that firms avoid a negative earnings change through earnings management that defers recognition of bad news relative to a control sample of firms that miss this earnings benchmark.

5.3 H2a and H2b – The Relation Between Prior Years' (Unconditional) Conservatism and Earnings Management to Meet or Beat Earnings Targets

In Table 4, we report the results of investigating the association between prior years' (unconditional) accounting conservatism and whether firms manage earnings to avoid a negative earnings surprise (H2a) and to avoid a negative earnings change (H2b). The first column reflects the results of estimating equation (3) using EM_a (earnings target is the most recent analyst forecast) as the dependent variable whereas EM_b (earnings target is last year's earnings) is the dependent measure for the estimation results reported in the second column.

The coefficient on PC_{it}, the measure of past (unconditional) conservatism is insignificant in both estimations and suggests that, in the presence of good news, the additional slack resulting

from conservative accounting is not necessary for firms to meet or beat earnings benchmarks. As expected, the coefficient on DR_{it}, the bad news (i.e., negative stock returns) indicator variable is significantly negative in both estimations; i.e., firm-years with bad news are less likely to meet or beat earnings benchmarks than firm-years with good news. However, the coefficient on $PC_{it}*DR_{it}$, the measure of past (unconditional) conservatism interacted with the bad news indicator variable, is significantly positive in both estimations with a p-value equal to 0.0756 when EM_a is the dependent variable and 0.0045 when EM_b is the dependent measure. These results, which are consistent with H2a and H2b, respectively, suggest that in the presence of bad news, firm-years with high past (unconditional) conservatism draw upon the accounting slack created by such conservatism to meet or beat earnings benchmarks. Finally, as expected, the coefficient on CFO_{it} (ΔCFO_{it}) when EM_a (EM_b) is the dependent variable is significantly positive, consistent with firm-years having higher (higher changes in) cash flows being more likely to meet or beat earnings benchmarks.

In summary, the results reported in Table 4 provide support for H2a and H2b and thus link past (unconditional) accounting conservatism to the abilities of firms to manage earnings to meet or beat the latest analyst forecast and last year's earnings, respectively.

5.4 Results of Tests Linking Earnings Management to Both Contemporaneous (Conditional) and Past (Unconditional) Conservatism

The results of tests linking earnings management to both contemporaneous (conditional) and past (unconditional) conservatism are reported in Table 5. We estimate the Basu (1997) model, equation (1), separately and report the estimated incremental return response coefficients associated with bad news (β_3) for four sub-samples based on whether the firm-year has high or low past (unconditional) conservatism ($PC_{it} = 1$ versus $PC_{it} = 0$) and meets or beats the earnings benchmark ($EM_a = 1$ versus $EM_a = 0$ in Panel A; $EM_b = 1$ versus $EM_b = 0$ in Panel B). When the

earnings benchmark is the latest analyst forecast, the estimated β_3 reported in the top left-hand cell of Panel A (when $EM_a = 0$ and $PC_{it} = 0$) is greater than the estimated β_3 for the other three sub-samples. This result, which is consistent with firm-years that fail to meet the latest analyst forecast and that have low past (unconditional) conservatism being the most conditionally conservative, is thus consistent with H1a and the Beaver and Ryan (2005) prediction concerning conditional conservatism. In contrast, the estimated β_3 reported in the bottom right-hand cell of Panel A (when $EM_a = 1$ and $PC_{it} = 1$) is less than the estimated β_3 for one of the other sub-samples. This result provides mixed evidence that firm-years that meet or beat the latest analyst forecast and that have high past (unconditional) conservatism are the least conditionally conservative.

Next, we repeat the above analysis with last year's earnings as the benchmark. As reported in Table 5, Panel B, the highest (lowest) estimated incremental return response coefficient associated with bad news, β_3, is in the top left-hand (bottom right-hand) cell. These results, consistent with expectations, suggest that firm-years that fail to meet last year's earnings and that have low past (unconditional) conservatism are the most conditionally conservative whereas the firm-years reflecting the least conditional conservatism are those that meet or beat this earnings benchmark and that have high past (unconditional) conservatism.

In summary, the patterns of incremental return response coefficients associated with bad news reported in Table 5 allow us to link together the results of testing our first two hypotheses with the Beaver and Ryan (2005) prediction that underlies our second set of hypotheses.

6. Conclusion

We investigate the relation between cross-sectional differences in past (unconditional) and contemporaneous (conditional) accounting conservatism and earnings management to meet

or beat earnings benchmarks. The bad-news firm-years that meet or beat earnings benchmarks have lower incremental return response coefficients than bad-news firm-years that fail to meet such benchmarks. Accordingly, this evidence suggests that firms successful in avoiding a negative earnings surprise and avoiding a negative earnings change contemporaneously engage in less conditionally conservative accounting practices than firms that have negative earnings surprises and changes.

In our tests of the relation between prior years' (unconditional) conservatism and whether firms meet or beat earnings benchmarks, we present evidence that in the presence of bad news past (unconditional) accounting conservatism is positively associated with whether firms avoid a negative earnings surprise or an earnings decline. This result is consistent with higher levels of past (unconditional) conservatism creating accounting slack that allows firms to avoid writing down net asset values when bad news is sufficiently low (Beaver and Ryan 2005).

Our results contribute to both the accounting conservatism and earnings management literature. The evidence that cross-sectional variation in both conditional and unconditional conservatism is associated with current and/or future earnings management not only adds to recent empirical evidence concerning accounting conservatism (e.g., Penman and Zhang 2002; Ahmed et al. 2002) but also casts doubt on the ability of accounting conservatism to constrain managers' income-increasing opportunistic behavior. Our results also provide evidence consistent with the theoretical predictions resulting from the Beaver and Ryan (2005) model of conditional and unconditional conservatism. Finally, we extend Barton and Simko (2002) and add another factor, past accounting conservatism, that helps explain why some firms miss earnings targets.

Interpretation of our results is subject to at least one potential limitation. To the extent that the Basu (1997) model is misspecified (e.g., Dietrich et al. 2005) and does not properly capture accounting conservatism, the results of our tests of the contemporaneous relation between conservatism and earnings management to meet or beat earnings targets are difficult to interpret.

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TABLE 1
Sample Selection

Panel A: Hypothesis 1- Cross Sectional Test of the Contemporaneous Relation Between Conditional Accounting Conservatism and Earnings Management to Avoid a Negative Earnings Surprise/Change Samples

	Earnings Surprise (H1a)	**Earnings Change (H1b)**
Firm-years with necessary data	31,856	56,299
Less: EPS_{it}/P_{it-1} or R_{it} below the 1st percentile or above the 99th percentile	574	1,552
Less: R_{it} not in the interval (-1, 1)	1,955	3,261
Sample	29,327	51,486

Panel B: Hypothesis 2- Cross Sectional Test of the Relation Between Past (Unconditional) Accounting Conservatism and Earnings Management to Avoid a Negative Earnings Surprise/Change Samples

	Earnings Surprise (H2a)	**Earnings Change (H2b)**
Firm-years with data to compute past (unconditional) conservatism measure PC_{it}	10,091	10,091
Less: Middle one-third of conservatism distribution	3,320	3,320
Firm-years with PC_{it} = 1 or 0	6,771	6,771
Less: Firm-years without data to compute other variables	3,916	2,441
Less: EPS_{it}/P_{it-1}, R_{it} and CFO_{it} below the 1st percentile or above the 99th percentile and R_{it} equal to -1 and above 1	155	242
Test samples	2,700	4,088

Notes to Table 1

EPS_{it}/P_{it-1} is earnings per share (EPSPX #58) in year t divided by price per share (PRCCF #199) at the end of year t-1.
R_{it} is the cumulative return for the firm's fiscal year.
EM_{it} is the earnings management indicator variable EM_a or EM_b.

EM_a is an indicator variable = 1 if the earnings surprise (IBES actual – Analyst Forecast) ≥ 0, EM_a = 0 if earnings surprise is < 0.

EM_b is an indicator variable = 1 if the change in scaled net income (NI #172- NI_{t_1})/($CSHO_{t\_2}$#25 * $PRCCF_{t\_2}$ #199) is ≥ 0, EM_b = 0 if the change in scaled net income is < 0.

PC_{it} is an indicator variable = 1 if the firm specific estimate of past (unconditional) conservatism, $-\alpha_i$, from estimating equation (4) is in the top third of the distribution and = 0 if it is in the bottom third of the distribution.

CFO_{it} is cash flows from operations per share (OANCF #308 – XIDOC #124)/CSHO #25 in H2a, and the change in cash flows from operations Δ(OANCF #308 – XIDOC #124)/CSHO #25 in H2b.

TABLE 2
Descriptive Statistics and Univariate Analysis for H1 and H2

Panel A: Hypothesis 1a- Cross Sectional Test of the Contemporaneous Relation Between Conditional Accounting Conservatism and Earnings Management to Avoid a Negative Earnings Surprise Samples: Positive Earnings Surprises (EM_a = 1) Versus Negative Earnings Surprises (EM_a = 0), where EM_a = 1 if Earnings Surprises ($IBES_t$ -$Forecast_t$) ≥ 0 and EM_a = 0 if Earnings Surprises < 0

	N	Mean	Std. Deviation	Maximum	Percentiles 75th	50th	25th	Minimum
EM_a = 1 Firm-years								
EPS_{it}/P_{it-1}	17,645	0.0343*	0.1182	0.5437	0.0800	0.0531*	0.0204	-3.7480
R_{it}	17,645	0.0704*	0.3752	1.0000	0.3222	0.0549*	-0.1964	-0.8940
EM_a = 0 Firm-years								
EPS_{it}/P_{it-1}	11,682	-0.0069*	0.1649	0.5549	0.0667	0.0351*	-0.0289	-3.3372
R_{it}	11,682	-0.0218*	0.3689	1.0000	0.2200	-0.0380*	-0.2857	-0.9001

Panel B: Hypothesis 1b- Cross Sectional Test of the Contemporaneous Relation Between Conditional Accounting Conservatism and Earnings Management to Avoid an Earnings Decline Samples: Positive Earnings Changes (EM_b = 1) Versus Negative Earnings Changes (EM_b = 0), where EM_b = 1 if Scaled Earnings Changes (NI #172- NI_{t_1})/($CSHO_{t\_2}$#25 * $PRCCF_{t\_2}$#199) ≥ *0 and EM_b = 0 if Scaled Earnings Changes < 0*

	N	Mean	Std. Deviation	Maximum	Percentiles 75th	50th	25th	Minimum
EM_b = 1 Firm-years								
EPS_{it}/P_{it-1}	28,930	0.0379*	0.1631	0.8750	0.0924	0.0619*	0.0286	-0.1681
R_{it}	28,930	0.0120*	0.3691	1.0000	0.3634	0.1122*	-0.1270	-0.8868
EM_b = 0 Firm-years								
EPS_{it}/P_{it-1}	22,556	-0.0654*	0.2553	0.8667	0.0496	0.0064*	-0.0890	-6.0160
R_{it}	22,556	-0.1077*	0.3556	1.0000	0.1137	-0.1301*	-0.3684	-0.9000

TABLE 2 (Continued)

Panel C: Hypothesis 2a- Cross Sectional Test of the Relation Between Past (Unconditional) Conservatism and Earnings Management to Avoid an Earnings Surprise Samples: Positive Earnings Surprises (EM_a = 1) Versus Negative Earnings Surprises (EM_a = 0), where EM_a = 1 if Earnings Surprises ($IBES_t$ -$Forecast_t$) ≥ 0 and EM_a = 0 if Earnings Surprises < 0

	N	Mean	Std. Deviation	Maximum	75th	Percentiles 50th	25th	Minimum
EM_a = 1 Firm-years								
EPS_{it}/P_{it-1}	1,861	0.0487*	0.0820	0.3764	0.0754	0.0524*	0.0315	-1.7671
R_{it}	1,861	0.0867*	0.3355	0.9842	0.3025	0.0572*	-0.1499	-0.7750
CFO_{it}	1,861	2.6726*	2.1747	11.6178	3.7260	2.2926*	1.3226	-15.2447
EM_a = 0 Firm-years								
EPS_{it}/P_{it-1}	839	0.0276*	0.1068	0.5549	0.0647	0.0450*	0.0164	-1.3006
R_{it}	839	-0.0038*	0.3285	1.0000	0.2183	0.0011*	-0.2391	-0.5165
CFO_{it}	839	2.3357*	2.1164	11.7324	3.4597	1.9148*	0.9217	-4.2817

Panel D: Hypothesis 2b- Cross Sectional Test of the Relation Between Past (Unconditional) Conservatism and Earnings Management to Avoid an Earnings Decline Samples: Positive Earnings Changes (EM_b = 1) Versus Negative Earnings Changes (EM_b = 0), where EM_b = 1 if Scaled Earnings Changes $(NI\#172 - NI_{t\_1})/(CSHO_{t\_2}\#25 * PRCCF_{t\_2}\#199)$ *≥ 0 and EM_b = 0 if Scaled Earnings Changes < 0*

	N	Mean	Std. Deviation	Maximum	75th	Percentiles 50th	25th	Minimum
EM_b = 1 Firm-years								
EPS_{it}/P_{it-1}	2,271	0.0668*	0.0823	0.6661	0.0890	0.0629*	0.0412	-1.7671
R_{it}	2,271	0.1372*	0.3295	0.9967	0.3454	0.1144*	-0.0916	-0.7910
CFO_{it}	2,271	0.2593*	1.6115	12.2758	0.7390	0.1786*	-0.2647	-12.9633
EM_b = 0 Firm-years								
EPS_{it}/P_{it-1}	1,817	-0.0015*	0.1398	0.3750	0.0597	0.0331*	-0.0024	-1.3125
R_{it}	1,817	-0.0536*	0.3216	1.0000	0.1413	-0.0728*	-0.2828	-0.8415
CFO_{it}	1,817	-0.0780*	1.8291	10.7263	0.5772	-0.0385*	-0.7134	-10.3027

Notes to Table 2

* Mean (or median) EM = 1 variable is significantly different from mean (or median) EM = 0 variable in two-sided tests of means (or medians), at the < 0.001 significance level

EPS_{it}/P_{it-1} is earnings per share (EPSPX #58) in year t divided by price per share (PRCCF #199) at the end of year t-1.

R_{it} is the cumulative return for the firm's fiscal year.

CFO_{it} is cash flows from operations per share (OANCF #308 – XIDOC #124)/CSHO #25 in H2a, and the change in cash flows from operations Δ(OANCF #308 – XIDOC #124)/CSHO #25 in H2b.

EM_{it} is the earnings management indicator variable EM_a or EM_b.

EM_a is an indicator variable = 1 if the earnings surprise (IBES actual – Analyst Forecast) ≥ 0, and EM_a = 0 if earnings surprise < 0.

EM_b is an indicator variable = 1 if the change in scaled net income (NI #172- NI_{t_1})/($CSHO_{t\_2}$#25 * $PRCCF_{t\_2}$#199) ≥ 0 , and EM_b = 0 if the change in scaled net income < 0.

For Panels A and B, firm-years are from the period 1984-2003. For Panels C and D, firm-years are from the period 1997-2003.

For Panels A and B, the sample is trimmed at the 1st and 99th percentiles based upon on the distribution of EPS_{it}/P_{it-1} and R_{it}. The distribution of R_{it} is trimmed at -1 and 1. For Panels C and D the sample is trimmed at the 1st and 99th percentiles based upon on the distribution of CFO_{it}.

TABLE 3
Results of OLS Regressions: Conditional Conservatism and Earnings Management to Avoid a Negative Earnings Surprise or Decrease in Earnings

$$EPS_{it} / P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 DR_{it} + \beta_3 R_{it} * DR_{it} + \varepsilon_{it} \qquad (1)$$

$$EPS_{it} / P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 DR_{it} + \beta_3 R_{it} * DR_{it} + \beta_4 EM_{it} + \beta_5 EM_{it} * R_{it} + \beta_6 EM_{it} * DR_{it} + \beta_7 EM_{it} * R_{it} * DR_{it} + \varepsilon_{it} \quad (2)$$

Panel A: Earnings Management to Avoid a Negative Earnings Surprise(H1a)

		Coefficient Estimates (p-values) by Sub-sample			
	Expectation	**Full Sample**	***EM$_a$*=1**	***EM$_a$*=0**	**Pooled**
Intercept	?	0.039	0.049	0.025	0.025
		(<0.001)	(<0.001)	(<0.001)	(<0.001)
R_{it}	+	0.027	0.026	0.016	0.016
		(<0.001)	(<0.001)	(0.038)	(0.017)
DR_{it}	?	0.004	0.005	0.002	0.002
		(0.093)	(0.062)	(0.635)	(0.571)
$R_{it}*DR_{it}$	+	0.182	0.160	0.204	0.204
		(<0.001)	(<0.001)	(<0.001)	(<0.001)
EM_{it}	?				0.024
					(<0.001)
$EM_{it}*R_{it}$	+				0.010
					(0.141)
$EM_{it}*DR_{it}$	?				0.003
					(0.569)
$EM_{it}*R_{it}*DR_{it}$	-				-0.044
					(0.002)
Adj. R^2		0.093	0.0932	0.0821	0.1058
N		29,327	17,645	11,682	29,327

TABLE 3 (Continued)

Panel B: Earnings Management to Avoid a Negative Earnings Change (H1b)

		Coefficient Estimates (p-values) by Sub-sample			
	Expectation	**Full Sample**	**EM_b=1**	**EM_b=0**	**Pooled**
Intercept	?	0.026	0.0518	-0.012	-0.012
		(<0.001)	(<0.001)	(0.006)	(0.001)
R_{it}	+	0.036	0.034	-0.037	-0.037
		(<0.001)	(<0.001)	(0.001)	(<0.001)
DR_{it}	?	0.008	0.017	0.006	0.006
		(0.009)	(<0.001)	(0.335)	(0.234)
$R_{it}*DR_{it}$	+	0.267	0.269	0.298	0.298
		(<0.001)	(<0.001)	(<0.001)	(<0.001)
EM_{it}	?				0.065
					(<0.001)
$EM_{it}*R_{it}$	+				0.036
					(<0.001)
$EM_{it}*DR_{it}$	?				0.012
					(0.060)
$EM_{it}*R_{it}*DR_{it}$	-				-0.028
					(0.050)
Adj. R^2		0.0874	0.0951	0.0448	0.1155
N		51,486	28,930	22,556	51,486

Notes to Table 3

EPS_{it}/P_{it-1} is earnings per share (EPSPX #58) in year t divided by price per share (PRCCF #199) at the end of year t-1.
R_{it} is the cumulative return for the firm's fiscal year.
DR_{it} is an indicator variable equal to 1 if R_{it} is negative, zero otherwise.
EM_{it} is the earnings management indicator variable EM_a or EM_b

- EM_a is an indicator variable = 1 if earnings surprise (IBES actual – analyst forecast) is ≥ 0, and EM_a= 0 if earnings surprise is < 0.
- EM_b is an indicator variable = 1 if the change in scaled net income (NI #172- NI_{t-1})/($CSHO_{t-2}$ #25 * PRCCF $_{t-2}$ #199) is ≥ 0, and EM_b= 0 if the change in scaled net income is < 0.

P-Values are one tailed for coefficient estimates with directional expectations and two-tailed otherwise.
Firm-years are from the period 1984-2003.
The sample is trimmed at the 1st and 99th percentiles based upon on the distribution of EPS_{it}/P_{it-1} and R_{it}. The distribution of R_{it} is trimmed at -1 and 1.

TABLE 4
Results of Probit Regressions: Past (Unconditional) Accounting Conservatism and Earnings Management to Avoid a Negative Earnings Surprise or Decrease in Earnings

$$EM_{it} = \alpha + \gamma_1 PC_{it} + \gamma_2 DR_{it} + \gamma_3 PC_{it} * DR_{it} + \gamma_4 CFO_{it} + \varepsilon_{it} \qquad (3)$$

		EM$_a$ **Earnings Surprise (H2a)**		***EM$_b$*** **Earnings Change (H2b)**	
	Expected Sign	**Coefficient Estimates**	**Prob > χ^2 p-value**	**Coefficient Estimates**	**Prob > χ^2 p-value**
Intercept	?	0.4186	<0.0001	0.4170	<0.0001
PC_{it}	?	0.0754	0.3282	-0.0166	0.7697
DR_{it}	-	-0.2750	0.0024	-0.7124	<0.0001
$PC_{it} * DR_{it}$	+	0.1947	0.0756	0.2322	0.0045
CFO_{it}	+	0.0363	0.0023	0.0622	<0.0001
Log Likelihood		-1,655		-2,675	
		n = 2,700		n = 4,088	

Notes to Table 4

EM_{it} is the earnings management indicator variable EM_a or EM_b.

EM_a is an indicator variable = 1 if earnings surprise (IBES actual – analyst forecast) is ≥ 0, and EM_a = 0 otherwise.

EM_b is an indicator variable = 1 if the earnings change (NI #172- NI_{t-1})/($CSHO_{t-2}$ #25 * $PRCCF_{t-2}$ #199) is ≥ 0, and EM_b = 0 otherwise.

PC_{it} is an indicator variable = 1 if the firm-year specific estimate of conservatism, $-\alpha_i$, from estimating equation (4) is in the top third of the annual distribution and PC_{it} = 0 if it is in the bottom third of the annual distribution.

DR_{it} is an indicator variable equal to 1 if R_{it} is negative, zero otherwise, where R_{it} is the cumulative return for the firm's fiscal year.

CFO_{it} is cash flows from operations per share (OANCF #308 – XIDOC #124)/CSHO #25 in H2a, and the change in cash flows from operations Δ(OANCF #308 – XIDOC #124)/CSHO #25 in H2b.

Firm-years are from the period 1997-2003.

The sample is trimmed at the 1st and 99th percentiles based upon on the distributions of CFO_{it}.

TABLE 5
Contemporaneous Conditional Conservatism Estimates by Earnings Management and Past Unconditional Conservatism

$$EPS_{it} / P_{it-1} = \beta_0 + \beta_1 R_{it} + \beta_2 DR_{it} + \beta_3 R_{it} * DR_{it} + \varepsilon_{it} \quad (1)$$

Panel A: Earnings Management to Avoid a Negative Earnings Surprise

	PC_{it} = 0 (Low)	PC_{it}= 1 (High)
EM_a=0		
β_3 Estimate	0.165	0.121
P-Value	(0.019)	(0.011)
	n=294	n=520
EM_a=1		
β_3 Estimate	0.102	0.110
P-Value	(0.002)	(<0.001)
	n=545	n=1,341

Panel B: Earnings Management to Avoid a Negative Earnings Change

	PC_{it} = 0 (Low)	PC_{it}= 1 (High)
EM_b=0		
β_3 Estimate	0.221	0.122
P-Value	(<0.001)	(0.001)
	n=813	n=894
EM_b=1		
β_3 Estimate	0.173	0.026
P-Value	(<0.001)	(0.087)
	n=1,004	n=1,377

Notes to Table 5

EPS_{it}/P_{it-1} is earnings per share (EPSPX #58) in year t divided by price per share (PRCCF #199) at the end of year t-1.

R_{it} is the cumulative return for the firm's fiscal year.

DR_{it} is an indicator variable equal to 1 if R_{it} is negative, zero otherwise.

EM_{it} is the earnings management indicator variable EM_a or EM_b.

EM_a is an indicator variable = 1 if earnings surprise (IBES actual – analyst forecast) is ≥ 0, and EM_a = 0 otherwise.

EM_b is an indicator variable = 1 if the earnings change (NI #172- NI_{t-1})/($CSHO_{t-2}$ #25 * $PRCCF_{t-2}$ #199) is ≥ 0, and EM_b = 0 otherwise.

PC_{it} is an indicator variable = 1 if the firm-year specific estimate of conservatism, $-\alpha_i$, from estimating equation (4) is in the top third of the annual distribution and PC_{it} = 0 if it is in the bottom third of the annual distribution.

P-Values are one tailed.

Firm-years are from the period 1997-2003.