

Debiasing the Measurement of Conditional Conservatism

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ABSTRACT

Basu's (1997) measurement of conditional conservatism as the timelier response of earnings to bad news than to good news underlies hundreds of studies on the determinants and effects of this form of conservatism. However, numerous subsequent studies cast doubt on the extent to which Basu's measure captures conditional conservatism as opposed to statistical biases or alternative constructs (collectively, "biases"). Many of these studies question the validity of the inferences that empirical researchers have drawn from their analyses using Basu's measure. We analyze the primary biases identified by these studies and modify Basu's measure in two simple ways to remove these biases. Our key modification is the inclusion of interactive controls for return variance, a scale proxy motivated by Patatoukas and Thomas' (2011) return variance effect. The inclusion of these interactive controls captures scale-related effects on both the *level* of earnings and the *sensitivity* of earnings to returns, and it allows the magnitudes of these effects to vary with the sign of returns. Using placebo tests, synthetic returns, alternative measures of conservatism, and other approaches, we show that our modified asymmetric timeliness measure is largely free of bias and associated with contracting-related variables as predicted by theory. We conclude that, after necessary surgical intervention, the news about the death of Basu's measure has been greatly exaggerated.

Keywords: Conditional conservatism, Asymmetric timeliness

JEL Classifications: C23, D21, G32, M4