Discussion of "Cash flow asymmetry: Causes and implications for conditional conservatism research" ☆

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ABSTRACT

Accounting researchers should not view CHT's analysis as the solution to our collective problem of being able to measure conditional conservatism. CHT provide evidence about earnings asymmetric timeliness and an accruals-based measure of asymmetric timeliness that is useful for evaluating construct validity. In some cases, CHT's evidence will translate directly to another researcher's setting. In other cases, CHT provide useful guidance for researchers to follow in conducting their own construct validity analysis. But it is ultimately the responsibility of each researcher to conduct his own construct validity analysis specific to his research question and sample.

1. Introduction

Tests of the economic role of conditional conservatism, defined as the outcome of an accounting system with asymmetric recognition of news, require the researcher to propose a proxy for conditional conservatism. The asymmetric timeliness estimate from a regression of earnings on returns proposed by Basu (1997) is one of the most commonly used measures of conditional conservatism. While Basu's conceptualization of conditional conservatism can be viewed as a breakthrough,[1] his asymmetric timeliness (AT) measures should be viewed only as a first step in the difficult process of developing valid empirical constructs for conditional conservatism. Ongoing research is essential to clarify and refine our understanding of the construct and improve our measures of it.

In that spirit, CHT should be viewed as only one element of a construct validity assessment of conditional conservatism.[2] Researchers should *not* view CHT's contribution as the development of a quick-fix solution to measuring conditional conservatism, and I appeal to researchers to read past the last sentence of the abstract and not to blindly follow the

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[1] Ball et al. (2013a) note that Basu (1997) conceptualized conditional conservatism as the asymmetry in the way that new information is conveyed through earnings as a result of differential verification standards. They describe his formulation of the concept as a "breakthrough" and argue that a market-based measure is a natural way to measure this conceptualization.

[2] Pioneers of construct validity techniques expressed their ideas about how the process should develop in different ways but the basic idea is the same: researchers should take a 360 degree view of a construct and accumulate evidence to infer its meaning. For example, Cronbach and Meehl (1955) suggest that construct validity involves elaborating the "nomological network" of a construct, which includes identifying how the construct relates to other constructs or observable properties. Early in the process, the network will be limited with few connections. Through time, ongoing research should attach a construct to more and more facts or other constructs. Campbell and Fiske (1959) discuss the necessity of showing convergent and discriminant validity and propose the multi-trait multi-method matrix.

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recommendation: "*Going forward, we recommend researchers use accruals-based asymmetric timeliness measures when testing for conditional conservatism.*" It would be irresponsible for a researcher to effectively outsource the task of construct validity analysis to CHT by using accruals AT as a proxy for conditional conservatism purely based on CHT's recommendation in the abstract. Each individual researcher bears the responsibility for developing a clear understanding of the dimension of conditional conservatism that is the object of interest in his study and for reviewing established metrics, including perhaps an accruals-based AT measure, as possible proxies. CHT's findings can contribute to the ongoing (and unending) process of improving measurement of conditional conservatism, and their analysis can guide researchers in how to conduct a construct validity analysis, but researchers should not view CHT as the final answer.

CHT offer two caveats to their recommendation to use accruals AT as a proxy for conditional conservatism, but they appear only at the end of the introduction. The first caveat is: "*In recommending accruals-based measures of DT, we are not claiming that this measure should be used in all conservatism studies going forward. Indeed, it seems the accruals-based approach is likely to be inappropriate in several important settings that are examined by accounting researchers…*" This caveat is essential because there is a potential for slippage between CHT's conceptualization of conditional conservatism and the use of the term "conditional conservatism" in the literature. CHT consider conditional conservatism to be the outcome of an accounting system that involves the application of "…differential verification thresholds for recognizing good news vs. bad news about *expected* future cash flows (i.e., *unrealized* gains versus *unrealized* losses…*" (p. 3, emphasis theirs)). Although CHT's definition is reasonable, this conceptualization is not used universally throughout the literature. Consider, for example, the discussion in Ball, Kothari, and Nikolaev (BKN, 2013a). They describe the Basu metric as deriving from conditional conservatism resulting from firm fundamentals and accounting discretion and even the interaction between the two. Although both CHT and BKN use the same term – "conditional conservatism" – BKN's notion of what the Basu measure could represent is clearly different.

Researchers must carefully assess their own research setting to determine the distinct notion of "conditional conservatism" that is the object of interest in their study. A theory may use the words "conditional conservatism," but if the theory is based on asymmetric timeliness due to fundamentals, or due to the interaction between fundamentals and the application of the accounting rules, then isolating the accruals component of asymmetric timeliness as a proxy for "conditional conservatism" could be inappropriate. As an example, consider theories about the role of "conditional conservatism" and debt covenants. Given that debt contracts are generally written on total earnings rather than just accruals, these theories are likely to assume that creditors factor CFO AT into the determination of the covenants, regardless of whether they view CFO AT as an indication of "conditional conservatism." As another example, consider models that assume that cash outflow realizations are more controllable than cash inflow realizations,[3] in which case asymmetric timeliness in cash flows is relevant to the decision maker. In summary, the concept of conditional conservatism that underlies the predictions being tested should determine whether including cash flow AT is appropriate to test any given study's predictions.

The remainder of my discussion is dedicated to expanding on CHT's second essential caveat related to using accruals AT as a proxy for conditional conservatism (i.e., excluding CFO AT from Basu's return-based metric): "*Moreover, we are not claiming that CFO asymmetry is the only factor that researchers may need to control for when testing conjectures about conditional conservatism.*" In Section 2, I provide a condensed summary of CHT's findings. The nuances of the findings, and the details of their sample and setting, are important when considering how and whether to "control for" CFO asymmetry by using accruals AT as a proxy for conditional conservatism. In Section 3, I describe the findings of three studies that are part of the larger literature on the Basu metric as a measure of conditional conservatism. These summaries provide examples of factors other than CFO asymmetry that researchers may need to control for, and on the flip side, they illustrate that controlling for CFO asymmetry may eliminate legitimate sources of conditional conservatism. Bear in mind that my coverage of the literature is incomplete. There are numerous studies on conditional conservatism, in general, and the Basu return measure, in particular. The scholarly debate about the Basu return measure as a proxy for conditional conservatism is vibrant, as it should be. I cite a limited number of examples; I apologize to the authors of the many papers I do not include.

2. Summary of CHT's findings

This section provides a condensed summary of CHT's key findings, highlighting the details and nuances of individual findings that are relevant for assessing the use an accruals-based AT proxy for conditional conservatism. Before considering CHT's findings, however, take note of the sample to which the findings relate. The CHT sample excludes financial institutions. This exclusion is sensible because proxies for constructs like growth opportunities (e.g., sales growth or market-to-book ratios) and financial distress (e.g., leverage) that are commonly used in other sectors are not reliable proxies for the same constructs in financial institutions. In addition, CHT's prediction that firms in the early life cycle stage will exhibit greater CFO AT does not translate well to the business models of financial institutions. CHT also exclude firms with negative book value of equity. This exclusion is noteworthy because firms with negative equity could be an important component of

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[3] CHT acknowledge this alternative explanation for cash flow asymmetry in Section 7. Table 10 shows that that CFO AT is not significantly different in write-down years vs. non-write-down years although accruals AT (obviously) is.

the sample in any study, and in fact could be the most relevant sample component when testing hypotheses related to conditional conservatism and debt contracting.[4]

While both sample exclusions are common in a large panel study like CHT, these exclusions mean that CHT's findings should not be used to justify the use of accruals AT as a proxy for conditional conservatism in different samples.[5] That being said, even for settings with a different sample, CHT's analysis provides a useful roadmap for researchers to follow to conduct their own sample-specific construct validity analysis.

Now the laundry list of results:[6]

(a) CFO AT exists (Table 2): CHT document that CFO AT represents a significant component of earnings AT. Other studies also document cash flow AT, although some (not all) use different definitions of cash flows (e.g., Basu, 1997; Ball and Shivakumar, 2006; Dietrich et al., 2007; Hsu et al., 2011, 2012). As noted in my introduction, cash flow asymmetry reflected in the Basu coefficient estimate could be at least part of the object of interest in a study of conditional conservatism. After establishing a clear conceptualization of "conditional conservatism" that is relevant in his study, a researcher should determine which, if any, cash flow components should be included in the dependent variable when estimating asymmetric timeliness.

(b) Life cycle and CFO AT (Tables 3 and 4): CHT propose that firms in the early life-cycle stage exhibit greater CFO AT. They expect a stronger association between CFO and good economic news (i.e., positive returns) for low-growth, mature firms. However, they expect a stronger association between CFO and bad economic news (i.e., negative returns) for early stage firms for which survival concerns are more significant. The proposition that growth is associated with earnings AT is not new (e.g., Ball et al., 2013a), although connecting growth to life cycle in this context is. Likewise, the proposition that financial distress is related to earnings AT is not new (e.g., Hsu et al., 2011), but connecting distress to life cycle is. CHT show that early stage firms exhibit greater CFO AT and interpret this finding as evidence that CFO reflects asymmetric timeliness that is not conditional conservatism. Recalling the discussion in my introduction, this interpretation is subject to the caveat that CHT's conceptualization of conditional conservatism does not include conditional conservatism exhibited in *realized* cash flows.

For the life cycle analysis, it is worth emphasizing what CHT do *not* do. They do not show that life cycle is the only or most significant explanatory variable for CFO asymmetry. They do not rigorously compare the associations between CFO AT and each component of the life cycle measure (i.e., size, age, capex and sales growth). They provide an extended analysis of the relation between sales growth and CFO AT because the basic analysis yields the unexpected result that CFO AT is significantly negatively related to sales growth. They show that the relation between CFO AT and sales growth is non-linear, but they do not explore whether this non-linearity also exists in the accruals AT measure.

In summary, the life cycle analysis is not designed to provide evidence that would justify CHT's recommendation to use an accruals-based AT metric for conditional conservatism. Even if a researcher shares CHT's conceptualization of conditional conservatism, CHT's analysis indicates only that CFO AT is on average correlated with life cycle. Eliminating *all* CFO AT may remove conditional conservatism unrelated to life cycle, yet relevant to addressing the research question. On the flip side, CHT do not demonstrate how (or whether) accruals AT is associated with life cycle. Thus, using an accruals-based AT measure does not necessarily eliminate a systematic relation between the conditional conservatism proxy and life cycle or its components. Life cycle, and/or its individual components, could remain an important correlated omitted variable in a conditional conservatism test.

(c) Firm size (Table 5): Prior research has documented a negative association between firm size and earnings AT and interpreted the evidence as consistent with agency cost explanations for conditional conservatism.[7] Givoly et al. (2007) question this interpretation, suggesting instead that the association is due to measurement error in the earnings AT proxy that is correlated with firm size. They show that firm size is related to the uniformity of events during typical estimation windows for Basu's AT metric: larger firms are less likely to have one large event that dominates the return measure during a period, possibly due to differences in liquidity or price discovery. Givoly et al. further show that controlling for the uniformity of events (DOM) eliminates the significant negative relation between earnings AT and size. They use this finding to support their argument that researchers should be careful when using earnings AT as a measure of conditional conservatism because measurement error in the proxy can lead to invalid inferences.

CHT enter this debate by comparing the relation between size and their accruals-based AT metric after controlling for the uniformity of events (DOM). They find a consistent and strong negative relation between size and accruals AT, as agency cost explanations for conditional conservatism would predict. They view this analysis as evidence of convergent validity for their measure. Again, an alternative interpretation is that the accruals AT measure eliminates something other than estimation error due to non-uniformity of events during the estimation window (DOM), and they have

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[4] The exclusion is also noteworthy because the percentage of firms with negative equity has been increasing over time (Jan and Ou, 2012).

[5] Even in broad samples that include financial institutions, researchers should conduct their own construct validity analysis to determine biases in an accruals-based AT proxy for conditional conservatism given that financial institutions represent approximately 20 percent of the Compustat population.

[6] The laundry list approach to describe CHT's individual findings is not unlike the conclusion in Givoly et al. (2007) in which they connect their individual findings to cautionary statements about the use of the Basu measure as a proxy for conditional conservatism in specific settings or situations.

[7] Basu (2001) provides additional possible explanations – risk/return volatility, diversification, and regulatory pressure, all of which are potentially correlated with size.

effectively created a new systematic bias in accruals AT related to size. In addition, as noted in footnote 13, CHT address only one of the situational biases suggested by Givoly et al. (2007). Researchers need to assess the impact of the other noted situations that lead to (potentially systematic) measurement error in an earning AT metric in their sample before concluding that accruals-based AT is an appropriate proxy for conditional conservatism. If the situations that produce biases are not important for a study's generalizability, eliminating the situations could be a viable alternative to using accruals AT as a proxy for conditional conservatism.

(d) Accruals AT and restatements (Table 6): CHT's restatement analysis assesses convergent validity of accruals AT as a measure of conditional conservatism. The basic finding is that accruals AT exhibits predictable time variation related to accounting misstatements, but earnings AT does not. Earnings AT is *positive* and significant during the misstatement period. Assuming restatements occur because firms were overstating earnings (i.e., *not* engaging in conservative accounting practices), this evidence of "conditional conservatism" during the misstatement period is opposite to expectations. Accruals AT, however, is insignificant (but not significantly negative) during the misstatement period, while it is positive and significant in the pre-misstatement period.[8]

CHT also find that accruals AT is positive and significant in the post-misstatement period, and they attribute this result to increased regulatory/auditor scrutiny following a restatement. While speculative, this argument suggests that conditional conservatism will be time-varying related to reporting incentives of both the firm and its monitors.[9]

(e) Scale effects and comparison to Ball, Kothari, and Nikolaev (BKN, 2013b) (Tables 7–9): BKN claim that the scale effects documented by PT are due to correlation between the expected components of earnings and returns that varies with returns. Controlling for this correlation in the regression to generate an earnings AT measure therefore addresses the scale effect bias. CHT's assertion, in contrast, is that earnings AT includes CFO AT, and that not all CFO AT reflects conditional conservatism. Thus, earnings AT metrics can be noisy or biased measures of conditional conservatism. Both studies are attempting to achieve the same broad goal of "moving the literature forward" by responding to concerns that the Basu measure is (fatally) flawed. However, BKN are focused specifically on explaining the source of the PT bias and suggesting an adjustment for this concern with the Basu measure as an empirical proxy for conditional conservatism, while CHT are focused on CFO asymmetry as a source of bias (or noise). Consistent with these different goals, BKN provide a model to motivate their suggested adjustment to remove scale effects, but CHT do not, although CHT discuss the potential association between their explanation (i.e., CFO asymmetry) and BKN's explanation (i.e., correlation).

CHT first show that the bias in earnings AT that Patatoukas and Thomas (PT, 2011) attribute to scale effects manifests only in the cash flow component of earnings AT and not in the accruals component (Table 7).[10] They next compare the asymmetric timeliness coefficient estimates from models of accruals (removing cash flows from earnings) to the estimates from BKN's adjusted model (removing the effects of correlation). The accruals AT estimate is 0.065 (Table 8, Model 3); the estimate for the BKN model is 0.114 (Table 8, Model 4). CHT note that the BKN asymmetric timeliness estimate is 75% higher,[11] which they interpret as evidence that the CHT approach eliminates "more bias" than the BKN estimate (p. 26) and that "bias" remains in the BKN estimate (p. 28). They also show that the AT estimate is positive and statistically significant in a regression model with a dependent variable that is CFO minus BKN's adjustment for the expected component of earnings (Table 8, Model 5). They interpret this finding as evidence that the BKN correction "… removes part of the *bias* due to CFO asymmetry" (p. 28, emphasis added).

CHT's interpretation of the collective findings – that accruals AT removes bias that BKN's metric does not – ignores the difference between the nature and purpose of the two adjustments, and it does not reflect caveats earlier in the paper recognizing that not all CFO asymmetry is "bias." Another interpretation of the lower coefficient estimate for accruals AT is that BKN's adjustment, which they theoretically motivate as the source of scale effects, eliminates the PT bias while the accruals-based measure not only eliminates the PT bias but also eliminates asymmetric timeliness that represents genuine conditional conservatism. Table 8 Panel B (Models 8 and 9) shows that scale effects remain in the BKN asymmetric timeliness measure, while they are not significant in the CHT measure.[12] This comparison is perhaps the most relevant to evaluating the two approaches, but CHT do not present a statistical comparison of the coefficient estimates.

The second element of the analysis compares the two "quick-fix" solutions for measuring conditional conservatism. CHT propose estimating asymmetric timeliness using accruals; BKN propose including firm fixed effects in the model. While these are "solutions" to different problems as noted above, this analysis focuses only on a comparison of the two approaches with respect to removal of scale effects. Table 9 Panels A and B show that lagged values of the dependent variable (i.e., earnings, CFO, and accruals) exhibit scale effects that are reduced when firm fixed effects are added to the models. CFO (lagged) exhibits the greatest reduction, which foreshadows their conclusion that the two approaches will yield similar results. In Panels C and D, CHT estimate asymmetric timeliness for contemporaneous dependent variables. They emphasize the finding that adding fixed effects decreases the "bias" in the AT estimate, primarily in CFO AT.

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[8] The relation between measures of conditional conservatism and restatements remains an open question (e.g., Ettredge et al., 2012).

[9] This speculation is consistent with time varying conditional conservative due to incentives such as litigation risk.

[10] Hsu et al. (2012) provide a similar analysis. See Section 3 of this discussion.

[11] CHT do not report a significance level for this difference.

[12] The most recent version of Patatoukas and Thomas (2014) claims that the bias still exists using the Collins et al. (2014) approach, although their discussion does not provide enough detail for me to comment on that claim.

Although CHT do not provide a formal statistical comparison, they conclude overall that the two quick-fix solutions "… accomplish the same thing" (p. 30). CHT also show that the asymmetric timeliness metric that would be used as a proxy for conditional conservatism is 0.078 when estimating accruals AT (Panel C) and 0.085 when including firm fixed effects in the earnings AT model. There is no statistical comparison, but I suspect the resulting estimates are not significantly different.

CHT end this section by comparing the merits of the two "solutions" given that (1) they result in similar AT estimates, (2) they have a similar effect on scale-related bias, and (3) they are both easy to implement. CHT observe that their method can be implemented in single-period studies, whereas firm fixed effects are only useful for panel data. The more salient observation, in my opinion, is that the two solutions are attempting to resolve different problems. CHT's recommendation to use an accruals-based AT proxy for conditional conservatism is not theoretically directed at removing scale effects (although empirically it does in their sample). However, it is not clear that this adjustment would remove scale effects in every sample. Moreover, removing CFO AT may remove more than scale effects. A similar comment can be made about BKN's firm fixed effects solution. While the approach removes the correlation that BKN assert is the source of scale effects, it also removes other firm effects that are not related to scale, if any, and potentially removes genuine conditional conservatism.

In summary, a significant contribution of the comparison is that it provides a thorough discussion of the scale effect issue that should increase awareness of its importance when assessing earnings AT or accruals AT as a proxy for conditional conservatism. CHT also provides a useful procedure for researchers to follow when assessing scale effects in an asymmetric timeliness proxy for their sample.

(f) Leverage, market capitalization ("size"), and market to book (MTB) ratios (Fig. 5): This analysis is intended to show that accruals-based AT is related to leverage, size, and growth opportunities as predicted by extant theory. As part of the analysis, CHT show that accruals AT for lagged values of accruals does not display the predictable relations, suggesting that scale effects do not explain the results. In summary, CHT find the predicted positive (negative) association between conditional conservatism and leverage (size). The results for MTB ratios vary based on the estimation window, as in other studies. Even in Panel D, in what CHT consider to be the appropriate estimation window, the authors describe the relation as positive, although it appears fairly flat.[13]

Establishing convergent validity by correlating accruals AT with other constructs as predicted by theory is a common and useful element of construct validity analysis, but CHT's portfolio analysis is limited and somewhat descriptive as it is only one part of the study. More extensive and rigorous analysis along these lines should follow. As an example, related to the leverage results, the entire Hsu et al. (2011) study, described in Section 3, analyzes the association between just financial distress and accruals AT.

In this section, CHT also document the association between BKN's adjusted asymmetric timeliness measure and leverage, size, and MTB ratios. Throughout the results discussion, CHT compare the performance of their accruals-based AT metric to BKN's measure as if the two approaches are in competition. As noted previously, the two approaches to adjust the Basu metric are motivated by different goals. The findings should be viewed as complementary, not competing, and the analysis is not designed to provide evidence that one approach or the other is more effective at mitigating bias.

Finally, based on the figures, it appears that there is some potentially interesting variation across the CHT and BKN metrics in the strength of their associations with leverage, size, and MTB ratios. The variation is not surprising given that the two approaches produce different measures of conditional conservatism. Subsequent work could attempt to exploit the difference in the two measures to test more precise predictions about conditional conservatism, leverage, size, and growth opportunities.

3. CHT in the context of the literature

This section summarizes findings from three studies on Basu's earnings AT metric as a measure of conditional conservatism with the goal of showing how CHT fits into the broader literature. Given the idea that construct validity analysis should involve developing a 360 degree view of a construct, *every* paper on conditional conservatism, including those directly aimed at construct validity, those that test economic hypotheses about conditional conservatism, and even those that simply document associations, are part of the broader literature. I discuss only three studies that are highly related.

(a) Hsu, O'Hanlon, and Peasnell (HOP, 2012) share CHT's goal of providing evidence that furthers our understanding of earnings AT as a measure of conditional conservatism, and their evidence overlaps with some of CHT's findings. Ultimately, they reach a similar conclusion that the cash flow element of earnings AT should be excluded

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[13] The significance is not reported. Based on a comparison to the slopes of the lines for lagged accruals in Panels A and B that are *not* significantly positive, and adjusting for differences in scale across the panels, I suspect the relation between accruals AT and market to book may not be significant in Panel D.

when estimating asymmetric timeliness as a proxy for conditional conservatism, albeit for a different measure of cash flows – cash flow from operating *and* investing activities (CFOI).[14] In their abstract, they state: *"With the important caveat that researchers should test the robustness of their results to the exclusion of the element of Basu coefficient due to cash flows, our findings are consistent with the conditional conservatism interpretation of the coefficient." (p. 87.)*

When evaluating whether to exclude cash flows from earnings and estimate an accruals-based measure of conditional conservatism, researchers should consider the combined evidence in HOP and CHT. HOP separately examine the asymmetric timeliness of investing accruals and operating accruals. In addition, they estimate AT for components of accruals including the change in accounts receivable, the change in inventory, the change in accounts payable, the change in other operating accruals, special and other non-operating items, interest income less interest expense, taxes, extraordinary items, and "dirty surplus" (other comprehensive income) items. Their findings for these specific accruals could help a researcher make more refined predictions about the determinants/consequences of conditional conservatism and thus conduct a cleaner test.[15]

(b) Hsu et al. (2011) find a positive association between financial distress and both CFO AT and accruals AT. Their definitions of cash flows from operations and accruals are identical to CHT's definitions: CFO is cash flow from continuing operations derived from the statement of cash flows and accruals is income before extraordinary items less CFO, and both studies scale CFO and accruals by beginning of period MVE. One implication of their finding that accruals-based AT is systematically related to financial distress is that following CHT's recommendation to use accruals AT when testing for conditional conservatism will not resolve concerns about financial distress as a potential omitted correlated variable. I emphasize this point because one of CHT's explanations for stronger CFO AT in early life-cycle stage firms is that negative economic news has greater implications for early stage firms that are assumed to be subject to greater concerns about financial distress. Thus, researchers might expect that by eliminating CFO AT, they are also eliminating the effects of distress on asymmetric timeliness, but they are not. Financial distress remains an alternative explanation for results of conditional conservatism tests if the explanatory variable of interest in the study is correlated with financial distress.

(c) Givoly et al. (2007) propose three categories of conditions that could create measurement error (noise) and/or bias in earnings AT as a measure of conditional conservatism: (1) non-uniformity in the content of the news during the estimation window (i.e., offsetting good and bad news); (2) multiple events in the estimation window that reflect different levels of discretion-related conditional conservatism; and (3) firms' disclosure policies, which can be asymmetric. As one example, Givoly et al. show that the earnings AT measure does *not* behave as expected for "big issuers" (big equity issuers) if it is measuring conditional conservatism. Givoly et al. do not investigate whether accruals AT does display expected variation, but neither does CHT.[16] Clearly, some of the "situations" in Givoly et al. will generate the type of asymmetry in CFOs that CHT assert does not represent conditional conservatism. But the overlap does not imply that an accruals-based AT measure mitigates the potential situational biases noted in Givoly et al. In assessing construct validity, researchers need to carefully consider whether eliminating CFO AT sufficiently addresses the situational biases noted in Givoly et al. If the situations that produce biases are not important for a study's generalizability, eliminating the situations could be a viable alternative.

4. Conclusion

My message is that each researcher is responsible for assessing construct validity of conditional conservatism in his study. An assessment should involve a clear conceptualization of "conditional conservatism" for addressing the research question and a setting and sample-specific analysis of possible measures. CHT contributes to the literature by providing evidence that is helpful to assess the Basu return regression measure as one possible proxy for conditional conservatism. However, their evidence should not be generalized to different samples without additional scrutiny, and it should not be viewed in isolation.

CHT's evidence should be viewed as one part of a complicated literature related to using Basu's return regression measure as a proxy for conditional conservatism. This endeavor is important because accounting researchers need a practical measure of conditional conservatism, and recent papers have recommended that we abandon the Basu return regression measure of earnings AT as a proxy for conditional conservatism due to fundamental and irresolvable biases (Dietrich et al., 2007; Patatoukas and Thomas, 2011). While these statistical criticisms are founded, CHT and others (Ryan, 2006; Ball et al., 2013a, 2013b) attempt to move the literature forward by understanding how these criticisms, which depend on the data structure, can be avoided or mitigated through adjustments to the approach rather than abandoning it.

Using an accruals-based AT metric *may* capture the researcher's intended conceptualization to address his research question. But it may also remove conditional conservatism that is relevant in a particular setting. It *may* control for relevant

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[14] One element of HOP is an analysis similar to CHT Table 7, in which they show scale effects documented in Patatoukas and Thomas (2011) are concentrated in their cash flow component of earnings (CFOI).

[15] See Ryan (2006) for additional examples of studies that separately examine accruals and cash flow AT for various definitions of accruals and cash flow.

[16] Such an analysis would be similar to the restatement analysis described previously. Assessing construct validity of accruals AT around financing activities is especially important given the evidence that financing issues distort measures of accruals and cash flows (e.g., Ball and Shivakumar, 2008).

omitted correlated variables that would otherwise affect inferences, but it does not necessarily remove all omitted correlated variables. Moreover, depending on the sample, removing CFO AT *may* unintentionally create a different bias in the proxy for conditional conservatism. Finally, it may be the case that in particular settings or samples, because of the data structure, the statistical problems with the Basu reverse regression measure are, in fact, irresolvable, and no adjustment will result in a return-based asymmetric timeliness estimate that is a reliable for proxy for conditional conservatism.

CHT's analysis can move the conditional conservatism literature forward so long as researchers view the paper as an empirical examination of the Basu earnings AT measure and do not blindly follow CHT's recommendation to use accruals AT when testing for conditional conservatism. CHT's analysis creates awareness of several important issues that researchers should consider when assessing empirical proxies for conditional conservatism, a goal shared by Ball et al. (2013a and 2013b), Givoly et al. (2007), Hsu et al. (2011 and 2012), Ryan (2006) and others. CHT's analysis also provides implementable approaches for researchers to follow when assessing construct validity of earnings AT or accruals AT for their setting and sample.

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