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The Link between Earnings Conservatism and the Price-to-Book Ratio*

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Abstract

We hypothesize and find that (1) earnings conservatism, the tendency of firms to recognize bad news in earnings on a more timely basis than good news, is substantially greater in portfolios of firms with lower price-to-book ratios than in portfolios of firms with higher price-to-book ratios; and (2) the negative association between earnings conservatism and the price-to-book ratio stems primarily from the accrual component of earnings, not the operating cash flow component of earnings. Our results suggest that studies using earnings-returns associations to investigate cross-sectional or time-series differences in earnings conservatism risk drawing erroneous inferences unless the research designs control for cross-sectional or time-series variation in price-to-book ratios.

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