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Accounting conservatism quality of accounting information and crash risk of stock prices ☆

Dimitrios V. Kousenidis [a], Anestis C. Ladas [b], Christos I. Negakis [b,*]

[a] *Aristotle University of Thessaloniki, Greece*
[b] *University of Macedonia, Greece*

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ABSTRACT

From an information perspective, sources of risk should be reflected in accounting fundamentals. However, asymmetry in disclosure generated from a decrease in information flow to users of financial statements may lead to a stock price crash when the news is eventually disclosed. The present study examines the impact of a number of accounting and auditing attributes that have been found to improve reporting efficiency on the prediction of stock price crash risk. The results indicate a negative relation between conditional conservatism and future stock price crash risk, which supports evidence in the existing literature but more importantly provide new evidence by showing that unconditional conservatism is also negatively related to future stock price crash risk. In addition some evidence shows that the level of unconditional conservatism affects the relation between conditional conservatism and future stock price crash risk. On the other hand, auditing attributes do not seem to have predictive ability for stock price crash risk while in consistency with the literature the relation between lagged earnings opacity and stock price crash risk is positive. Taken together, the results imply that researchers should disentangle the effects of the two forms of conservatism when assessing the likelihood of a future stock price crash and that the beneficial role of conservatism in reducing stock-crash risk should be not overlooked.

1. Introduction

Stock price crash risk (henceforth denoted as *SPCR*) has been the topic of a rapidly growing literature over the last decade. Chen, Hong, and Stein (2001), one of the first studies in the area, support that a likely source of *SPCR* is the discretionary delay in the reporting of bad news by the management of the firm. Moreover, Hutton, Marcus, and Tehranian (2009) argue that managers are inclined to systematically withhold negative information about a firm; however, this information is eventually disclosed and leads to a sudden drop in stock prices implying that *SPCR* is closely related to information asymmetry.

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* Corresponding author at: Department of Accounting and Finance, University of Macedonia, Egnatias 156, 54006, Thessaloniki, Greece.
E-mail address: negakis@uom.gr (C.I. Negakis).

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Apart from the relation between *SPCR* and opaque financial statements, the relevant literature also provides links between *SPCR* and conditional conservatism (Kim & Zhang, 2013), tax avoidance (Kim, Li, & Zhang, 2011a), internal control (Kim, Song, & Zhang, 2011b) and management (Andreou, Antoniou, Horton, & Louca, 2013). However, there is no comprehensive study on the relation of *SPCR* with measures of quality of accounting information. Such a study could provide important information about the relation of a number of accounting and auditing attributes and *SPCR*. For example, it is widely recognised that from an information perspective, accounting fundamentals should reflect the firm's sources of risk.[1] Accounting treatments such as impairments and provisions lead to the faster recognition of bad news in the firm's financial statements and reduce information asymmetry. In other words, any news with a potentially negative impact for the firm should be incorporated into its financial statements more quickly than news with a potentially positive impact in order to signal a higher likelihood of risk to users of those statements. The faster recognition of bad news is usually termed news-dependent (or conditional) conservatism in the relevant literature (Basu, 1997), and it is argued that conditional conservatism reduces information asymmetry and hence the likelihood of a stock price crash (Hu, Li, & Zhang, 2014; Kim & Zhang, 2013).

In addition to conditional conservatism, the literature has identified a second form of conservatism, which is news-independent and broadly known as unconditional conservatism. In contrast to its conditional counterpart, unconditional conservatism does not always lead to a reduction in information asymmetry. LaFond and Roychowdhury (2008) argue that unconditional conservatism leads to a nontimely penalty in earnings by expensing the full amount of costs and deferring the full amount of any likely benefits. In contrast, conditional conservatism leads to an understatement of net assets only if related (bad) news is present. However, as Biddle, Ma, and Song (2013) argue, unconditional conservatism may also be beneficial in reducing risk due to its role in the reduction of earnings management. As a result, Biddle et al. (2013) emphasise that conservatism may reduce cash outflows and increase cash inflows and consequently it may provide a better financial position for the firm and reduce the likelihood of negative news related to the firm.

Both types of conservatism should be important during a period in which the stock price faces increased crash risk. This is expected for two reasons; the first reason is the elimination of litigation risk and the second is the improvement in the financial position of the firm. Concerning the first, litigation risk increases during a crisis period (Jenkins, Kane, & Velury, 2009). Hence, it is expected that the higher is the crash risk, the higher will be the litigation risk. Hamm, Li, and Ng (2014) argue that high litigation risk mitigates opportunistic behaviour in guiding the users of financial statements and as a result reduces agency problems. In turn it would be plausible to assert that firms become more conservative and consequently the discretionary behaviour is limited. As have been found by Qiang (2007) conservatism of both forms (conditional and unconditional) is negatively related to litigation risk. Stated differently firms exercise conservatism to reduce litigation risk. Concerning the second, conservatism of both forms has been found to improve the financial position of the firm by reducing leverage and enhancing liquidity (Biddle et al., 2013).

Thus, it is not surprising that although the two forms of conservatism have been found to be negatively related in the short run, they are positively related in the long run (Ball, Kothari, & Nikolaev, 2013; Biddle et al., 2013). Beaver and Ryan (2005) explain the negative short-run relation by indicating that unconditional conservatism functions as a buffer and lowers the need for conditional conservatism. Therefore, when examining the relation between conservatism and stock price crashes, the research methodology should unravel the effects of the two forms of conservatism. Finally, some auditing determinants such as the size of the auditing firm may lead to lower information asymmetry and as a result increase auditing quality (i.e., Francis & Wang, 2008). Consequently, it is expected that the presence of a Big 4 auditing firm will lead to a lower likelihood of *SPCR*.

The present study extends prior literature by examining whether the presence of accounting and auditing quality attributes play a significant role in reducing future *SPCR* and thus in increasing the quality of accounting information. In specific the present study examines the effects of conservatism as well as its role as either complements or substitutes of accounting and auditing determinants in the prediction of *SPCR*. Because the incidence of a future crash is related to the current quality of accounting data, we focus on accounting and auditing attributes of the firm that are related to accounting data of higher quality which in turn lead to lower future crash risk. Specifically, we incorporate a number of accounting attributes that are related to the quality of accounting data—specifically, the level of conservatism and opacity of earnings. More interestingly, because conservatism can take two forms, we attempt to provide additional evidence in the literature by disentangling the effects of the two conservatism forms on future *SPCR*. Last, we use the presence of a Big 4 auditing firm or a qualified audit report in a previous year as an indicator of lower information asymmetry and thus lower likelihood of *SPCR* in the current year.

The results of the study indicate a negative relation between conditional conservatism and future *SPCR*. Moreover, unconditional conservatism is also negatively related to future *SPCR*, which indicates that unconditional conservatism is beneficial in reducing future *SPCR*. In addition, the level of unconditional conservatism seems to affect the relation between conditional conservatism and future *SPCR* in some of the research settings examined. Last, auditing attributes do not seem to have predictive ability for *SPCR* and earnings opacity seems to be positively related to future *SPCR*. Taken together, the re-

[1] For example, impairments and provisions can be considered cases in which the higher likelihood of risk regarding an unfavourable event is recorded in financial statements.