Asymmetric Timeliness and Delayed Recognition of Bad News

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Abstract: This article examines whether the asymmetric timeliness measure captures delayed recognition of bad news and in which manner this delayed recognition occurs. I find that negative earnings changes of firms with high asymmetric timeliness have significant predictive power for future earnings changes of low-asymmetric-timeliness firms in the same industry. In contrast, the negative earnings changes of firms with low asymmetric timeliness do not have predictive power for future earnings changes of high-asymmetric-timeliness firms in the same industry. Moreover, neither type of firm has predictive power for the other group when earnings changes are positive. This result suggests that high-asymmetric-timeliness firms recognize the effects of a common negative shock before low-asymmetric-timeliness firms. Further, low-asymmetric-timeliness firms have more frequent and smaller negative earnings changes, suggesting that the eventual recognition of negative news “trickles out” as opposed to being recognized in an “earnings bath.”

Keywords: asymmetric timeliness, conservatism, earning prediction

INTRODUCTION

Asymmetric timeliness (AT) is defined as the requirement for a higher standard for the recognition of good news than bad news in earnings (Basu, 1997). An implication of this definition is that firms with low AT delay the recognition of bad news in earnings. This article provides evidence for the existence of this delayed recognition and the manner in which it occurs using an AT measure suggested by Kahn and Watts (2009). This evidence lends support to the validity of an AT measure based on Basu’s (1997) nonlinear regression of earnings on returns.

I find that negative earnings changes of firms with high AT have significant predictive power for future earnings changes of low-AT firms in the same industry. In con-
 Contrast, the negative earnings changes of firms with low AT do not have significant predictive power for future earnings changes of high-AT firms in the same industry. Moreover, neither type of firm has predictive power for the other group when earnings changes are positive. This result suggests that high-AT firms recognize the effects of a common negative shock before low-AT firms. In addition, I find that low-AT firms have more frequent and smaller negative earnings changes, suggesting that the eventual recognition of negative news “trickles out” as opposed to being recognized in an “earnings bath.”

AT is one of the key characteristics of accounting. Research relates Basu (1997)’s measure of AT to contracting efficiency, persistence of special items, cost of capital, and corporate governance (Frankel & Roychowdhury, 2007; Zhang, 2008; LaFond & Watts, 2008; Francis & Martin, 2010). Recent studies, however, raise questions about the reliability of this measure, arguing that it is biased by economic events and disclosure policy (Givoly, Hayne, & Natarajan, 2007). Dietrich, Mueller, and Riedl (2007) also question whether this measure captures delayed recognition of earnings. Using a test that does not employ stock returns, I provide evidence that Basu’s measure captures the tendency to delay the recognition of bad news in earnings following the definition of AT.

Unrecognized bad news will eventually affect earnings, because cash flows are more highly correlated with earnings over long windows (e.g., Dechow, 2004). An effective AT measure should be able to detect this delayed recognition of common bad news across firms. Thus, I predict that negative earnings changes of high-AT firms will precede negative earnings changes of low-AT firms in the same industry if the measure is effective.

Following Khan and Watts (2009), I measure firm-specific AT based on Basu’s nonlinear regression of earnings on returns. Using this measure, I find negative earnings changes of high-AT firms predict earnings changes of low-AT firms in the next period within the same industry. However, I find that negative earnings changes of low-AT firms do not predict earnings changes of high-AT firms. These results provide evidence that the AT measure detects cross-sectional differences in the speed of recognition of bad news.

Given that firms with low AT delay recognition of bad news, I investigate how this retained bad news makes its appearance in earnings. Firms can choose either to recognize the accumulated bad news at one time (“earnings bath”) or to recognize it slowly (“trickling out”). The method chosen has implications for earnings forecasts. “Earnings bath” firms will have less frequent but greater-magnitude negative earnings changes, while “trickling out” firms will have more frequent and smaller-magnitude negative earnings changes. These results suggest that low-AT firms trickle out the past