

## **Earnings Conservatism and Audit Quality: An Examination of the Late 1990s**

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We investigate whether accounting conservatism decreased in the late 1990s and find that, consistent with anecdotal evidence, there was indeed a general decline in earnings conservatism. We also investigate whether high quality auditors were effective in stemming the decline in the reported conservatism. Our results indicate that client firms of Big Six auditors reported a significant decline in conservatism. However, such was not the case for client firms of Big Six industry specialist auditors, which indicates a role for industry specialist auditing in preserving reporting integrity when incentives for aggressive reporting may be high.

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### **INTRODUCTION**

In this paper, we focus on earnings conservatism, an important attribute of earnings information and investigate whether there were any conditional changes in this important attribute during the late 1990s. The stock trading period of the late 1990s was remarkable in many respects, including the high volume of trading that occurred, the record levels of public participation, and the manifestation of price-earnings multiples not seen in many decades. For instance, price/earnings multiples of the S&P 500 index, representing stocks of some of the largest traded firms listed on American exchanges, reached record levels of 40 or more (see Figure 1 and Shiller (2000) for a complete discussion). In its wake, numerous financial reporting improprieties have been uncovered (Byrne et al. 2002; Edmondson and Tierney 2002). These include high profile audit failures (e.g., Enron), material misstatements (e.g., WorldCom), and hundreds of restatements of financial reports. The occurrence of the unusual trading period of the late 1990s and the reporting problems that materialized subsequently raise questions about the impact of unusual stock trading behavior on accounting conservatism, which is an important attribute of reported earnings.<sup>1</sup>

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<sup>1</sup> The essence of the Basu (1997) conservatism measure is captured by the adage, “anticipate no profit, but anticipate all losses.” Measuring the degree to which adherence to this principle changes over time may provide information that is useful to regulators, auditors and forensic examiners in assessing the extent to which earnings are being more aggressively reported.