Financial reporting under economic policy uncertainty

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Abstract

In this paper, I discuss financial reporting under economic policy uncertainty. This paper is one of the first papers to relate economic policy uncertainty to financial reporting behaviour. It identifies the link between economic policy uncertainty and financial reporting in terms of earnings management and fair value accounting. It argues that high economic policy uncertainty will transmit fewer new information to firms which can motivate managers to influence accounting numbers in the direction of the desired financial reporting outcome. The discussion in the paper adds to our understanding of how economic conditions affect financial reporting outcomes.

Keyword: economic policy uncertainty, financial reporting, accrual, accounting quality, policy uncertainty; loan loss provisions, earnings management, fair value accounting.

JEL classifications: G21; M41; M40; M48; G32.

1. Introduction

Should firms use accounting techniques to influence financial reporting outcomes in times of high economic policy uncertainty? To date, there is little or no answer to this question in the accounting literature. Also, the accounting literature does not provide a definitive stance on whether the choice of accounting techniques in financial reporting is influenced by economic policy uncertainty, which is an important macroeconomic factor affecting corporate decisions in the business environment in recent years.

Previous studies have investigated how a firm's contractual attributes (e.g., the presence of bonus plans, or debt covenants), accounting rules (e.g., changes in accounting regulation) or a particular event (e.g., initial public offer, debt or equity issue) create incentives for managers to influence financial reporting outcomes (Arthur et al, 2019). But these studies do not take into consideration the macroeconomic environment of the firm. Such studies hold macroeconomic conditions constant or assume that macroeconomic conditions do not influence financial reporting outcomes (Biddle et al, 2009; Carcello and Nagy, 2004; Barth and Schipper 2008; Doyle et al, 2007).

Other studies examine whether firms manipulate reported earnings during non-economic events that propagate some form of uncertainty to firms, such as changing accounting and/or regulatory conditions, changes in standard-setting and accounting regulation, new rules that limit managerial discretion, risk aversion behavior, among others (see, for instance, Han and Wang (1998), Filip and Raffournier (2014), Cohen et al (2014), Dimitras et al (2015), Cimini (2015), Ozili and Arun (2018), and Ozili (2019)). These studies show that the propensity for managers to engage in earnings management is higher during events that depress firms' profit.

High economic policy uncertainty can depress firm's profit through its effect on the pricing, repricing, investment, divestment and cashflow decisions of firms. Yet, the relationship between economic policy uncertainty and financial reporting has received little attention in the literature. This is surprising given that financial reporting techniques are one of the most important tools that managers can use to minimize the negative effect of high economic policy uncertainty on

their balance sheet. This paper fills this research gap by providing a discursive analysis of the relationship between financial reporting and economic policy uncertainty.

The primary goal of this paper is to scrutinize the role that financial reporting, relating to earnings management and fair value accounting, plays in mitigating the impact of high economic policy uncertainty on firms. Although financial firms are more severely affected by economic policy uncertainty compared to non-financial firms (Zhang et al, 2015; Demir and Ersan, 2017), the focus of this paper is on the effect of economic policy uncertainty on the financial reporting of both financial firms and non-financial firms. This is because financial reporting serves as a way to communicate the financial performance and financial position of both financial firms and non-financial firms in high economic policy uncertainty environments. Therefore, I begin by discussing the differing objectives of financial reporting to help clarify that the information which standard setters require firms to provide in financial statements are intended to be decision useful and value relevant to capital markets and other users of financial information.

Next, I offer insights into whether high economic policy uncertainty creates risk information that managers use to make appropriate judgments regarding the value and riskiness of affected assets and liabilities. I also summarize available research evidence, and where appropriate, I offer some suggestions regarding possible improvements in financial reporting under economic policy uncertainty. The analysis in this paper leads us to conclude that high economic policy uncertainty leads to a change in financial reporting techniques. I argue that managers can selectively use accounting techniques in financial reporting to adjust their balance sheet in response to high economic policy uncertainty in the business environment. This conclusion is consistent with that of other scholarly analyses of the link between economic policy uncertainty and firm behavior (Ng et al, 2020; Zhang et al, 2015; Demir and Ersan, 2017).

This study contributes to the literature in two aspects. Firstly, this study contributes to the financial reporting literature by showing the channel through which high economic policy uncertainty affects firms' financial reporting. I argue that economic policy uncertainty affects financial reporting through decrease in cash inflow and revenue receipts to firms from customers, and increase in operating costs from suppliers, which can influence managers to accelerate future

income to the current year, and defer current expenses to future years in order to protect their balance sheet from deteriorating in times of high economic policy uncertainty. Secondly, this study contributes to the growing literature on economic policy uncertainty (e.g. Baker et al., 2014; Baker et al, 2016; Nguyen and Phan, 2017; Phan et al, 2019, etc). This study adds to this growing literature by extending the economic policy uncertainty debate to financial reporting, in order to identify how policy uncertainty affects accounting practice, particularly, financial reporting. This is one of the first study to conceptually examine how economic policy uncertainty affects firms' financial reporting.

The rest of the paper is structured as follows. Section 2 presents the conceptual framework. Section 3 discuss the literature. Section 4 discuss how economic policy uncertainty affects financial reporting in relation to earnings management and fair value accounting. Section 5 concludes the paper.

2. Conceptual framework

2.1. Objectives of financial reporting

According to the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), the objective of financial reporting is to provide information that is useful to present and potential investors, creditors and other users in making investment, credit, and similar resource allocation decisions (FASB, 2008; IASB, 2008; Barth and Landsman, 2010). This specific objective of financial reporting applies mainly to general purpose financial reporting for all firms, regardless of industry or whether firms in a particular industry are subject to greater or fewer regulation (Barth and Landsman, 2010). The Financial Accounting Standards Board (FASB) issues the US GAAP while the International Accounting Standards Board (IASB) issues the international financial reporting standards (IFRS). These two standards do not explicitly give managers the discretion to make accounting changes in response to high economic policy uncertainty or unexpected economic policy changes but it gives managers the discretion to influence the recognition and timing of accruals.

2.2. Uncertainty and financial reporting

Uncertainty in financial reporting generally arises from whether future accounting regulations will limit the ability of managers to make judgements on the recognition and timing of accruals in financial reporting. But such uncertainty is reduced when accounting standards create sufficient freedom for managers to exercise their discretion in recognizing certain transactions in financial reporting. While prior research has not examined the direct impact of uncertainty on financial reporting, other studies have examined the impact of uncertainty in several accounting contexts and events. For instance, Mayhew et al (2001) examine whether accounting uncertainty influences auditor objectivity, and find that the presence of accounting uncertainty impairs auditors' objectivity by inducing auditors to misreport accounting estimates in favor of managers. Chen et al (2013) show that managers in firms where there is low information-uncertainty engage in earnings management for informative purposes while managers in high-information-uncertainty firms engage in earnings management for opportunistic purposes.

Cormier et al (2013) document a positive relationship between earnings management and information asymmetry among Canadian firms, and show that the positive relationship between earnings management and information asymmetry is weakened for Canadian firms operating in uncertain environments characterized by high sales volatility. Their findings imply that investors will find it difficult to detect earnings management in uncertain environments, and indicates that financial reporting is rather opaque in uncertain environments. Huihui (2010) show that high environment uncertainty leads to higher absolute discretionary accruals, and the positive association is weaker for prosperous firm than for failing firms. Taken together, these studies show that higher uncertainty reduces the transparency of financial reporting, which ultimately has implications for value relevance and decision usefulness of financial statements to investors.

2.3. The Concept of Economic Policy Uncertainty

Economic policy uncertainty refers to uncertainty regarding current and future economic policies such as monetary policy, fiscal policy or regulatory policy (Danisman et al, 2020, Ng et al, 2020). economic policy uncertainty derives mainly from whether existing economic policies will change in the near future or the unknown impact of new economic policies on the private sector (Baker

et al. 2016; Danisman et al, 2020). Economic policy uncertainty has many sources. It may arise from inflation uncertainty, recessionary pressures, lending cuts, rising unemployment rate, sudden currency devaluation, rising fiscal deficit, change in government, uncertain tax policies, increased political polarization, budget deficits, change in governments following elections and trade wars (Hassett and Metcalf, 1999; Bordo et al., 2016; Talavera et al., 2012; Danisman et al, 2020; Ozili, 2020).

Notably, Baker et al (2016) identify four major sources of economic policy uncertainty, which are: (i) newspaper-based reports on the economy, (ii) tax code expirations, (iii) disagreement over CPI forecasts, and (iv) disagreement over government purchases forecasts. Baker et al (2016)'s economic policy uncertainty sources are often aggregated into a single economic policy uncertainty index, and the index has been widely used by many empirical studies to test the effect of economic policy uncertainty on firm behavior and economic activities in the literature (e.g., Bhagat and Obreja, 2013; Brogaard and Detzel, 2015; Gulen and Ion, 2016; Nguyen and Phan, 2017; Danisman et al, 2020; Ozili, 2020).

In theory, economic policy uncertainty, especially those that affect private firms, can affect the production, financing, and investment decisions of firms. The rational expectation of firms and other economic agents is to adjust their fundamentals in response to high economic policy uncertainty in the environment. High economic policy uncertainty will make firms delay investment decisions and reduce cash outflow as a precaution as firm managers become uncertain about whether economic policies (regulatory, fiscal and monetary policies) might change in the near future, and whether such economic policy changes will put their firms at a competitive advantage or disadvantage in the business environment.

3. Literature review

This section presents an overview of the literature that examine how economic events and economic factors affect financial reporting outcomes in order to gain some insight into how economic policy uncertainty might affect financial reporting.

Stein and Wang (2016) examine the effect of economic uncertainty on earnings management in firms. They argue that firms may opportunistically shift earnings from uncertain years to more certain years in the presence of managerial short-termism and asymmetric information about skill and effort provision. They show that firms report more negative discretionary accruals when financial markets are uncertain about their future prospects, and the stock-price responses to earnings surprises are weakened when firm-level uncertainty is high. Cohen and Zarowin (2007) examine the association between economic conditions and the tendency for firms to engage in income-increasing earnings management, and show that the tendency for firms to meet or exceed earnings benchmark is significantly related to the market-wide price to earnings (P/E) ratio.

Ascioglu et al (2012) argue that earnings management should increase information asymmetry and impair trading liquidity in capital markets. Using a large sample of NYSE firms from 1996 to 2001, they show that firms that engage in greater earnings management have lower market liquidity, and their results are robust when they use both real and accrual based measures of earnings management. Jin et al (2019) examine whether economic policy uncertainty is related to bank earnings opacity. They argue that when economic policy is uncertain, bank managers will find it easier to distort financial information. They further argue that economic policy uncertainty can increase the fluctuation in banks' earnings and cash flows, which provides additional incentives and opportunities for bank managers to engage in earnings management. In their analysis of US banks, they show that high economic policy uncertainty is positively related to earnings opacity, proxied by the size of discretionary loan loss provisions and the likelihood of meeting or exceeding the prior year's earnings. They also observe that the impact of economic policy uncertainty on financial reporting distortion is less pronounced for stronger banks (i.e., banks with high capital ratios).

Filip and Raffournier (2014) examine the impact of the 2008-2009 financial crisis on the earnings management behaviour of European listed firms. They find that income smoothing, a form of earnings management, decreased in crisis years. A possible explanation for this result is that managers may have less incentive to manipulate earnings in crisis years due to a higher market tolerance for poor performance in crisis years. Also, it is possible that litigation risk might increase during crises which can discourage insiders from engaging in earnings management. Similarly, Dimitras et al (2015) examine the consequences of global financial crisis on the earnings management practice of European companies, focusing on financially distressed companies that were audited by big 4 auditors during recession years. They find that financially distressed companies that were audited by a big 4 auditor exhibit lower discretionary accruals. On the other hand, Silva et al (2014) and Ozili and Arun (2018) find that earnings management is more pronounced during crisis years. Makhaiel and Sherer (2018) investigate the effect of political-economic reform on financial reporting quality among Egyptian companies, and find that the Egyptian political-economic reform led to the privatisation of firms, and also led to lower financial reporting quality.

A body of literature examine the economic consequences of financial reporting. Graham et al (2005) examine the economic implications of financial reporting, and predict that managers expect severe market reaction to missing an earnings target. For this reason, firms are willing to sacrifice economic value in order to meet a short-run earnings target. In a survey of financial executives, they find that the preference for earnings smoothing is so strong that 78% of the surveyed financial executives would give up economic value in exchange for smooth earnings in order to meet a short run earnings target. Also, 55% of the surveyed financial executives would avoid initiating a very positive NPV project if it meant falling short of the current quarter's consensus earnings. Cohen (2003) investigates the economic consequences of firms' financial reporting choices, and find that firms choosing to provide financial information of higher quality do not enjoy a lower cost of equity capital rather they had higher cost of equity capital, after accounting for the endogeneity associated with the financial reporting quality choice of firms. Li and Shroff (2010) argue that information uncertainty amplifies decision making difficulty and agency problems, and that better financial reporting quality can mitigate these two problems.

They predict that better financial reporting quality can improve project identification and selection, and lower the cost of capital which translates to faster economic growth. In their empirical analysis, they find that high information uncertainty industries grow disproportionately faster in countries with better financial reporting quality.

4. Discussion

4.1. Fair value accounting during times of high economic policy uncertainty

Fair value has been defined by the two accounting standards board (IASB and FASB) as the price agreed upon to sell an asset or to transfer a liability by a willing buyer and seller, assuming both parties are knowledgeable and enter the transaction freely at the measurement date. During the 2008 global financial crisis, IFRS and the US GAAP permitted firms to recognise some financial instruments at fair value while the changes in fair values are recognized in profit or loss during the 2007/2008 global financial crisis. In the aftermath of the crisis, fair value accounting was criticized for its contributory role in worsening the global financial crisis. Critics argued that fair value is not the best measurement attribute for conveying decision-useful information to financial statement users during a financial crisis, and that some other type of measurement attribute is more decision-useful such as the modified historical cost (Penman, 2007). This is because if there are no observable market prices on which to determine the fair value estimates, the estimates will lack decision usefulness because managers will have the opportunity to manipulate the estimates to meet their own financial reporting objectives (Barth and Landsman, 2010). Palea (2014) assess the usefulness of fair value accounting to financial statement users, and argue that fair value accounting alone cannot provide information useful to evaluate stewardship, and that historical cost accounting is also needed. This implies that a dual measurement and financial reporting system may deliver a more complete and useful information to financial statement users.

In times of high economic policy uncertainty, firms will increase the price of goods and services, and managers can choose to selectively recognise permissible assets and liabilities, or financial instruments, at fair value, and the changes in fair values will be recognized in profit or loss during

times of high economic policy uncertainty. Managers may rely on the observable market prices to determine the fair value estimates, and the fair value price is expected to be decision useful. Moreover, because some firms have access to superior private information than other firms during times of high economic policy uncertainty due to their affiliation with policy makers and government officials, the fair values determined by the prevailing observable market prices alone may not reflect the private information which management has, which means that the determined fair value amounts may lack decision usefulness.

To mitigate this problem, fair values during times of high economic policy uncertainty should reflect both the fair value (i.e., the observable market price agreed by the market participants) and other valuable private information that is relevant to the transaction. In other words, management will adjust the observed market prices to reflect the fair values of permissible assets and liabilities, and any other valuable private information attributes that are specific to the asset or liability. After making such adjustments, it is yet to be seen whether the resulting fair value accounting amounts, particularly in the context of high economic policy uncertainty, would lack sufficient quality to be informative to investors and other financial statement users.

In the broader literature, there is substantial evidence that fair values are relevant to investors for investment and equity decision making (see Venkatachalam, 1996; Barth, 2004; Song et al, 2010; Siekkinen, 2016; Ge et al, 2010; Agostino et al, 2011; Liao et al, 2020), but currently, there is no evidence for the value relevance of financial reporting during times of high economic policy uncertainty. A major problem that may arise from fair value accounting amounts during times of high economic policy uncertainty is the quality of fair value information. The type of information and model used to generate fair value estimates can transmit extreme volatility in reported earnings in uncertain times, and Barth (2004) show that such volatility can arise from either (i) the underlying economic volatility reflected in changes in assets' and liabilities' fair values, (ii) induced-volatility arising from using a mixed-measurement accounting model, that is, volatility arising from measuring some assets and liabilities at fair value and others at modified historical cost), and (iii) volatility induced by measurement error in estimates of fair value changes (Barth, 2004; Barth and Landsman, 2010).

Generally, earnings volatility is often higher during unstable times, as we have seen during the global financial crisis. Similarly, high economic policy uncertainty often makes markets unstable (Belke et al, 2018; Kang and Ratti, 2013), and increases the cost of capital (Xu, 2020; Drobetz et al, 2018). High economic policy uncertainty affects investment and business decisions (Kang et al, 2014), and can affect firms' pricing decisions (Ashraf and Shen, 2019; Raza et al, 2018), and subsequently affect the balance sheet of firms; thus, any fair value estimates determined during times of high economic policy uncertainty may lack decision usefulness to investors because such fair value amounts may reflect too much non-accounting information induced by high economic policy uncertainty such as managers' fear of future price changes. Therefore, it is easy to conclude that fair value accounting amounts might be less value relevant during unstable and uncertain times, and more value relevant during stable and certain times. Evidence from academic research addressing the value relevance of fair values in times of high economic policy uncertainty is not yet available, which could help to refute or validate this claim. Despite the argument above, it might be premature to conclude that fair values determined during times of high economic policy uncertainty may lack relevance and reliability if the determined fair values reflect the true and underlying economic reality of the assets and liability at the measurement date.

4.2. Earnings management during times of high economic policy uncertainty

Economic policy uncertainty may induce greater variability in reported earnings. Managers may try to reduce the effect of economic policy uncertainty on earnings volatility through earnings management. According to Healy and Wahlen (1999), earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy and Wahlen, 1999, p.368). The motivations for earnings management are classified in two main categories: market-related motivations and those resulting from agency relationships (Filip and Raffournier, 2014). Regarding market-related motivations, several studies document evidence that firms manage earnings upward to avoid reporting losses, earnings decline or negative earnings surprise (Burgstahler and Dichev, 1997; Degeorge et al., 1999; Ayers et al., 2006). There is also evidence that firms inflate their earnings prior to seasoned equity offerings

or initial public offerings (Rangan 1998; Teoh et al., 1998; Fan, 2007). Regarding agency-related motivations, empirical studies show that earnings management can be used as a tool to influence the execution of contractual agreements in agency relationships, such as managers manipulating earnings to increase their earnings-based compensation (Guidry et al., 1999), or to avoid debt covenant violation (DeFond and Jiambalvo, 1994; Dichev and Skinner, 2002).

Economic policy uncertainty is an important macroeconomic factor affecting firms (Kang et al, 2014; Wang et al, 2014), and there is evidence that macroeconomic conditions can affect earnings quality. For instance, Johnson (1999) documents that the value relevance of accounting earnings is sensitive to changes in the business cycle. Johnson show that the association between earnings and stock returns is higher during expansion periods than during recessionary years. Jenkins et al (2009) argue that the information content of reported earnings may vary across the business cycle. They find that earnings are more value relevant during recessionary years than during expansionary periods. Wang et al (2015) examine the degree of income-increasing earnings management by firms during business cycle fluctuations, and find that income-increasing earnings management is significantly correlated with economic expansion, indicating a strong pro-cyclical effect between earnings management and the business cycle.

The relationship between economic policy uncertainty and earnings management is not very clear. This is because firms can discretionarily reduce accruals (i.e., reduce accrued expenses) to hide bad news arising from higher economic policy uncertainty and to avoid signaling to investors that the firm is performing badly during times of high economic policy uncertainty. This may motivate managers to reduce accruals (accrued expense) to increase earnings in times of high economic policy uncertainty which implies a positive association between economic policy uncertainty and earnings management. On the other hand, firms might take an earnings bath in times of high economic policy uncertainty by increasing accruals (accrued expenses) in order to create cookie jar reserves that can later be used to boost future earnings, and such firms can blame policy makers for their additional losses, using it as a cover for reporting additional losses in times of high economic policy uncertainty. Increasing accruals (e.g., accrued expenses) in order to report a loss or to reduce profit in times of high economic policy uncertainty serves as a way for managers to signal the depressive effect of economic policy uncertainty on firm's earnings,

which implies a negative association between economic policy uncertainty and income-increasing earnings management in firms.

Currently, there are only few studies, precisely four studies, that address the effect of high economic policy uncertainty on accounting accruals. Ng et al (2020) show that US financial firms keep higher accounting accruals in response to high economic policy uncertainty. Similarly, Danisman et al (2020) extend the work of Ng et al (2020) using a large sample of US financial firms. They also show that US financial firms increase accruals in times of high economic policy uncertainty. Yung and Root (2019) report a positive relationship between policy uncertainty and earnings management. They show that firms increase (decrease) earnings management when policy uncertainty is high (low). Their study shows that uncertainty-induced earnings management is not influenced by national culture or other country-level institutional characteristics. Bermpei et al (2019) also find a positive relationship between EPU and earnings management.

4.3. Implications

4.3.1. Implication for financial firms

The implication for financial firms is that managers of financial firms can manipulate specific accounting numbers in financial reporting to signal the current and future depressive effects of high economic policy uncertainty on their financial performance assuming managers are more concerned about risk and investors' perception. Financial firms that have robust risk management systems may be able to better withstand shocks arising from high economic policy uncertainty by keeping higher prior earnings reserves which can be used to mitigate the depressive effect of economic policy uncertainty on firm earnings. It is also possible that managers of such financial firms can use the prior earnings buffer to mitigate unexpected shortfall in earnings.

Consider the case of banks as an example. In the financial sector, banks are special due to their unique accounting treatment and regulations. Banks play an important role in providing credit to the domestic economy. They are required to keep loan loss provisions to mitigate credit losses arising from their lending activities (Ozili and Outa, 2017). High economic policy uncertainty in

the business environment can induce banks to keep higher loan loss provisions as a precaution in anticipation of unknown future events that might affect banks' loan portfolio (Danisman et al, 2020), and the increase in bank provisions will reduce bank's earnings. The major concern is that high economic policy uncertainty can make bank managers keep provisions more than necessary – i.e., too much provisions – which can severely deplete banks' net interest margin and profitability, and can have severe impact on economic growth.

On the other hand, some banks faced with high economic policy uncertainty may prefer to keep fewer loan loss provisions to opportunistically report higher earnings, possibly to avoid perceptions that the bank is weak and to avoid attracting regulatory scrutiny and negative perception to investors (Ng et al. 2020; Danisman et al, 2020). Also, it is possible that prudent banks that have prior loan loss reserves are likely to be less affected by high economic policy uncertainty (Danisman et al, 2020), and such banks may keep fewer discretionary provisions in response to high economic policy uncertainty. Regarding fair value accounting in banks, we know that banks' credit risk tends to increase in times of high economic policy uncertainty and it is possible to advocate for an extended use of fair values in times of high economic policy uncertainty because using fair value to value assets and liabilities in time of high economic policy uncertainty can lead to a decrease (increase) in the value of liabilities, which results in a gain (loss) and a commensurate increase (decrease) in equity, thereby affecting banks' balance sheet.

Policymakers need to be careful when formulating policies that generate uncertainty in the financial sector because it has crucial implications for the size of accruals in financial firms particularly for banks. Regulatory bodies should formulate and implement policies in a transparent manner while governments should develop stable and predictable economic policies so that financial firms can plan ahead and make crucial investment and lending decisions. High economic policy uncertainty is undesirable as it makes managers' use their discretion to opportunistically manipulate accruals to manage earnings thereby reducing earnings quality. Although regulatory bodies can impose additional accounting discipline to limit managers' discretion in times of high economic policy uncertainty, such restrictions can have negative effects on the balance sheet of financial firms and can create negative earnings surprise to investors, thus discouraging investors from investing in the financial sector.

4.3.2. Implication for non-financial firms

Generally, economic policy uncertainty affects the financial and investment decisions of the firm (Yung and Root, 2019), and will have implications for business decision making in non-financial firms. High economic policy uncertainty in the business environment may transmit fewer new information to managers of non-financial firms which can make them change the firm's production, hiring and investment decisions. When governments issue unstable and unexpected economic policies, such policies will transmit shocks to economic agents which can induce non-financial firms to respond by increasing the cost of production, deferring major investment and delaying hiring decisions as a precaution against unknown future economic events. The change in firms' production, hiring and investment decisions in times of high economic policy uncertainty will transmit new information to the markets, and the changes in the markets will be reflected in the increase in operating costs and fall in cash flow, thus affecting the balance sheet of non-financial firms.

During high economic policy uncertainty, managers in non-financial firms can use real earnings management techniques that disguise as normal operational activities to manipulate earnings. For instance, managers of non-financial firms can use changes in cash flow from operations, sale of fixed assets, delay projects, decrease in research and development (R&D) expenditure, decrease in advertising and maintenance costs in order to meet earnings targets or a desired financial reporting objective, and there is evidence for this under several contexts in the accounting literature (see, Roychowdhury (2006), Cohen et al (2008), Cohen and Zarowin (2010), Burgstahler and Dichev (1997), Graham et al (2005), and Gunny (2010)). One implication for policy making is that governments should stimulate economic activities by issuing stable and predictable economic policies which non-financial firms can rely on to make important production, investment and hiring decisions. Policy makers should also reduce economic policy uncertainty so that economic agents, including firms, will respond rationally to economic policies which is crucial for successful government interventions.

5. Conclusion

This paper discussed financial reporting under economic policy uncertainty. The major argument in the paper is that high economic policy uncertainty may transmit fewer new information to firms which can motivate managers to manipulate accounting numbers to meet some desired financial reporting outcome.

This study adds to the accounting literature by showing that economic policy uncertainty can affect financial reporting outcomes. It also contributes to the economic literature by examining the adverse effects of economic policy uncertainty on firm behavior. This is an important issue because high economic policy uncertainty in the business environment can lead firms to make sudden adjustments in their business decisions, and such changes can affect the balance sheet of firms.

The discussion in this study should be of interest to standard setters, regulators and policy makers, given the longstanding debate on how government policy and regulation affect firms (e.g. Chen et al, 2008; Hu et al, 2012; Zhao et al, 2019). Reducing high economic policy uncertainty should be a priority for policy makers because it can mitigate unwanted practices of firms such as lobbying and the indiscriminate increase in pricing, which are common in uncertain environments.

The limitation of the study is that the study did not conduct any empirical analysis to test the relationship between economic policy uncertainty and financial reporting for financial and non-financial firms. Finally, even though this paper has linked economic policy uncertainty to two aspects of financial reporting, namely, earnings management and fair value accounting, it is still unclear whether and how economic policy uncertainty affects other aspects of financial reporting quality and choices. I leave this question to future research.

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