Discussion

Economic policy uncertainty and incentive to smooth earnings: Evidence from India (Chauhan & Jaiswall, 2020)

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Motivation

Research question and Big picture

• Research question: What is the financial reporting response by firms to economic policy induced uncertainty (EPU).

Firm actions in response to EPU

- Influence policy
  - Lobbying, political connectedness

- Manage outcomes at firm level

- Cash Flows
  - Real actions
    - Investment, M&A, Hiring, Cash holding

- Risk
  - Information based actions
    - Voluntary disclosure, financial reporting, income smoothing
Examining reporting response

*Why firms choose to manage reporting?*

- Reporting response is the outcome of the demand and supply for financial information.

- EPU results in loss of price informativeness (Pastor and Veronesi, JF 2012) and would therefore impact the demand and supply of information:
  - Andrei, Friedman, and Ozel (2019, WP) et al. suggest EPU would attract investor attention to firm-specific information around earnings announcements.
  - However, what about *supply* of information?
    - firms increase voluntary disclosure (Nagar, Shoenfeld, and Wellman, JAE 2019).
    - Financial reporting? Chauhan and Jaiswal (this paper) plugs a gap in our knowledge about the supply of financial information - an important contribution.

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Expectations on reporting outcomes
What should firms do?

- Ghoul, Guedhami, Kim, and Yoon (TAR 2020) show that accounting quality increases during periods of high EPU.

- They measure accounting quality using discretionary accruals and the data is derived from 16 countries, including India.
  - Ghoul et al. results seem to at variance from this paper.

- This paper shows that firms report more negative discretionary accruals in response to high EPU.

- So what could explain this variance?
Reporting choice - underlying explanations?

Teasing out alternative explanations

- Income decreasing accruals could be:
  
  A) reflecting genuine negative accruals to reflect business pessimism (for example: inventory write downs).

  B) reflective of cookie-jar reserves to be used for future income smoothing (authors explanation).

- The authors can separate these two explanations
  
  - If earnings forecasts are lower for future periods, it could be indicative of the business pessimism (A) whereas if earnings forecast remain at current levels it could be consistent with planned income smoothing (B)
Accruals Measurement

How and what to measure?

• Accruals are impacted by level of firm activity (investment and sales).
  • EPU in turn impacts investment and Sales.
  • Therefore measured discretionary accruals are combining both real actions and reporting choices.
  • Suggestion: Condition sample on real actions.

• Longstanding debate in earnings management literature about role of firm performance on accruals
  • Better performing firms will have higher accruals (Receivables, Inventory, Depreciation, …) and so “not controlling for performance can induce a spurious indication of discretionary accruals” (Kothari, Leone, and Wasley, JAE 2005)
  • Authors partition firms based on performance which could induce mis-measurement in accruals.
  • Suggestion: Performance matching on return on assets controls for the effect of performance on measured discretionary accruals.

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Using a regime shift in context of EPU

Rich possibilities in India setting

- Currently the paper uses the time series of firm-specific EPU sensitivity.
- India offers a few interesting regime shifts - for example Demonetization.
- Authors could examine reporting quality responses to the regime shift.
- Offers an alternative to firm-year discretionary accruals and instead authors could use accruals quality in each regime.
  - For example the Dechow-Dichev measure of accruals quality.
  - Avoids some of the measurement issues with Accruals.
Conclusion

• Timely and interesting paper that reflects the heightened interest in understanding implications of EPU.

• Particularly relevant for India.

• Little evidence exists with respect to reporting choices in light of EPU.

• Authors should examine their choices with respect to measurement and tease out alternative explanations.

• Best of luck!

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