FIRM-LEVEL POLITICAL RISK AND EARNINGS SMOOTHING

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ABSTRACT:

I examine whether firms exposed to political risk actively engage in earnings smoothing. I further investigate the effects of political risk and financial constraints on earnings smoothing. Using novel data on firm-level political risk developed by (Hassan et al., 2019) by adapting tools from computational linguistics and textual analysis of firms' quarterly earnings conference calls, I find that firms exposed to political risk use discretionary accruals to smooth earnings to mitigate the risk perceived by investors actively. The results support my conjecture that enhanced earnings uncertainty from political risk motivates firms to smooth earnings. However, the financial constraints inhibit earnings smoothing and, hence, firms' value and reputation in the financial markets when exposed to political risk.

Keywords: Firm-political risk, earnings smoothing, earnings management, textual analysis.

1. INTRODUCTION

Earnings management is widely practiced in the corporate world, and one special case of earnings management, earnings smoothing, is well documented in the earnings management literature. For example, (Graham et al., 2005) report that managers express strong interest in smoothing their reported earnings and keeping their firms' cash flow constant. Prior studies suggest managers make discretionary accounting choices, usually through discretionary accruals, to smooth reported earnings for several reasons, both to improve the firm reputation in the financial markets and to increase managers' private self-benefit. Investors consider earnings volatility to be associated with a higher risk, so firms with a lower level of earnings volatility or stable income can enjoy a lower cost of external financing and higher credit rating. (Trueman & Timan, 1988) point out that high perceived earnings volatility is associated with a higher perceived bankruptcy probability of the firm and, hence, its borrowing costs. Therefore, managers use discretionary accounting choices to report smooth earnings to affect market perceptions of earnings volatility and the firm's value. The second major motivation for managers to manipulate earnings, e.g., smooth earnings, is to achieve predetermined performance targets to obtain their private gain. Job security and executive compensation packages are often designed to align firm performance with manager's compensation. Managers are more likely to report smooth earnings if their reputation, job security, and total compensation value depend on whether their firm's performance meets performance targets or exceeds predetermined financial thresholds delineated in their compensation contract. In a theoretical paper on job security and earnings smoothing, (Fudenberd and Tirole's, 1995) model suggests that job security creates incentives for managers to smooth earnings considering current and future relative performance.

Prior studies show that political risk affects firm policies in several aspects. In general, when facing higher political risk, firms tend to cut capital investments, reduce corporate hiring, reduce their capital investment, limit the number of debt types, and increase precautionary savings and cash holding. In this paper, we employ a new measure of political risk developed by (Hassan et al., 2019) by using a textual analysis of earning conference calls to explore the effects of political risk on earnings smoothing. Specifically, to construct a new measure for potential risk, they employ textual analysis of transcripts of the quarterly earnings conference call to develop a novel measure of firm-level political risk faced by individual U.S. firms. I contribute to the current literature by examining whether firms actively smooth earnings when facing a higher level of political risk.