

Trump presidency to affect the quality of financial reporting information

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The number of companies using 'creative accounting techniques' can be expected to increase in Republican-governed states and decrease in Democrat-governed states when Donald Trump becomes US President tomorrow, according to new research from the University of Bath.

Widely seen in recent accounting scandals, companies under pressure from analysts and investors can resort to manipulating financial reports to hide financial performance, or at best present an overly positive impression of the [company](#)'s profitability, through practices known as 'earnings management'.

The study, published in the *Journal of Accounting and Public Policy*, found that companies are more likely to use earnings management techniques when they are headquartered in states with a higher political alignment with the [federal government](#).

For Obama's Presidency, Democrat states, such as California, were more politically aligned with the federal administration than Republican Red states, such as Texas. The opposite is set to be true with Trump's Presidency.

The results point to the Trump Presidency leading to an increase in earnings management for companies located in Republican-governed states; and a decrease in earnings management for companies based in Democrat-governed [states](#).

Analysis of companies that actively pursue corporate political strategies by either lobbying or making contributions to political active committees showed these companies have less incentive to manage earnings because they are able to counter the economic effects of political alignment using their direct connections with politicians.

Researchers from the University of Bath, along with the University of Graz, the Vrije University Amsterdam and the University of Southern Florida, looked at more than 11,000 listed firms over a 42 year period (1966-2008) to investigate how earnings management is affected by the outcome of political elections.

A possible explanation of the results is that when state and federal government are in alignment it is easier to implement new policies, causing a fluctuation in a company's profitability. Turning to earnings management techniques is a way for business managers to smooth out the variation in their finances and signal a consistent performance to shareholders.

Political alignment creates an additional incentive for earnings management because fluctuating profitability makes it more difficult for outsiders to scrutinise managers' behaviour.

Dr Pietro Perotti, Lecturer in Accounting & Finance in the University of Bath's School of Management, said: "We find that political geography plays a role in explaining financial reporting decisions within a single country. Our results send an alert to those interested in the quality of financial reporting and, in particular, to regulators and investors."

More information: Christian Gross et al, The financial reporting consequences of proximity to political power, *Journal of Accounting and Public Policy* (2016). [DOI: 10.1016/j.jaccpubpol.2016.06.007](https://doi.org/10.1016/j.jaccpubpol.2016.06.007)

Provided by University of Bath

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