

Economic Policy Uncertainty and Management

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ABSTRACT

First of all, this paper analyzes the concept of economic policy uncertainty. It then analyzes the connection and influence of economic policy uncertainty on our real-life from the two practical application examples of residents' consumption and enterprise development. The following paper introduces the definition of earnings management and describes its relationship with the independent director, corporate governance, and sex according to former experience. And then investigate that the relationship between economic policy uncertainty and earnings management can be negative or positive. It is relative to the government's supervision of the company, the impact of specific policies on the company's profits, information asymmetry, and the current stage of development of the company.

Keywords: component, economic policy uncertainty, household consumption, inflation, earnings management, independent director, corporate governance, sex, positive, negative.

1. INTRODUCTION

The economic policy uncertainty means that economic agents cannot predict with certainty whether, when, and how the government changes its current economic policy [1].

The economic policy uncertainty mainly refers to the adjustment of economic decision-making to affect the behavior of economic subjects due to the change of market development situation. Its uncertainty can be manifested as the uncertainty of political decision-making and the uncertainty of the influence of consumer behavior. Or what kind of policies policymakers will adopt to adjust the uncertainty of the behavior of economic agents, or what kind of uncertainty the policy adjustment behavior of policymakers will have on the present or future of economic agents [2].

As for earnings management, Healy and Wahlen believe that earnings management occurs when the enterprise management uses professional judgment to prepare financial reports or changes financial reports through planning transactions. That aims to mislead stakeholders' understanding of the company's performance or influence the results of signing based on the earnings of accounting reports [3]. Dechow and Skinner divide the enterprise's approach to earnings into four aspects: conservative, neutral, aggressive, and

fraudulent. The first three items are within the scope of generally accepted accounting standards, while financial fraud is in violation of GAAP [4]. Goel and Thakor believe that earnings management refers to manipulating reported earnings so that they cannot accurately reflect economic returns at each point in time [5].

This paper explains the relationship between economic policy uncertainty (EPU) and earnings management through two aspects. On the one hand, some scholars believe that the increase in economic policy uncertainty leads to more usage of firm earnings management. Pastor et al. [6] and Dai et al. [7] believe that EPU causes a firm's stock prices to fall. Company personnel must be relatively accurate in judging the influence of economic policy change on the firm. While other market participants have a sense of distrust of the firm, which may further cause the stock price to fall. Therefore, Cui et al. [8] believe that earnings management should be used as an adjustment method as soon as possible. In addition, [9] Chen and Chen find that EPU makes firms with high-profit accounting information attract the government's attention. The firm uses earnings management to adjust report data to avoid suspicion. And to reduce the tariff increase caused by EPU, the firm also chooses to strengthen the use of earnings management.

On the other hand, some documents have recorded that the increase in economic policy uncertainty prevents part of earnings management. [10] Kim and Ho find that EPU reduces a firm's corporate activities. They explain that when the Korean government has a new leader, it is common for checks firms to determine whether the previous government has corruption and other behaviors, thereby reducing earnings management. In addition, [11] Roma et al. took US firms as a sample. They found that companies in the phase of introduction, growth, and decline reduce earnings management when policy uncertainty emerges or becomes stronger.

2. ECONOMIC POLICY UNCERTAINTY

2.1. The relationship between uncertainty economy policy and household consumption and inflation

Consumption plays an important role in promoting the healthy development of the economy. Still, at present, the consumption growth of Chinese residents is relatively slow, and the consumption capacity is insufficient. However, from the perspective of the current effect of economic policy implementation, the policy has not achieved the expected effect, and the problem of residents' low consumption level has not been substantially improved. The continuous introduction of policies indicates a high degree of policy uncertainty in practice [12].

Household consumption is inseparable from economic policies. Wu et al. find that the fluctuation of economic policy uncertainty has a positive or negative impact on household consumption in the short term but has a significant negative impact in the medium and long term. Secondly, when the economic policy uncertainty fluctuates, it will increase the level of inflation to some extent, and the impact will be more serious in the short run. In contrast, the impact will be less in the long run [13]. In short, economic uncertainty will have a negative impact on China's household consumption, and if it is not solved in time, there will be greater future trouble.

Different scholars have different views on economic policy uncertainty and inflation. Li [14] proposed the concept of "sticky expectation" based on Keynes's view that inflation expectation is closely related to policy uncertainty. He believed that reducing the degree of economic policy uncertainty would be more helpful for the government to control inflation. Jin [15] believes that the relationship between economic policy uncertainty and inflation is not a simple one-way relationship, but there may be an interactive relationship. Zhu and Cai [16] believe that the impact of monetary policy uncertainty was greater, while the impact of fiscal policy uncertainty was more sustainable. So the relationship between economic

policy uncertainty and inflation is a two-way one, rather than a one-way one.

2.2. The impact of uncertainty economy policy on business investment and financing decision

China is in a special period when the industrial reform and the rising uncertainty of the international political and economic environment overlap each other [17]. The comprehensive deepening of reform, supply-side structural reform, price regulation, economic new normal and other major judgments, and the five major events such as the new development concept have increased the uncertainty of the external environment. With the increase of economic policy uncertainty, the investment environment of firms will have profound changes [18].

Many previous literatures hold different views on it. For example, the economic policy uncertainty is an inevitable systemic risk for firms. The increase of uncertainty will increase the risk of firms' investment in developing new products and innovation [19]. Moreover, each increase in economic policy uncertainty will lead to a slowdown in the growth of equity financing or debt financing, which is more obvious and exacerbates the financing constraints faced by firms. However, the policy uncertainty also contains favorable financing timing. In 2008, the financial crisis led to a sharp rise in policy uncertainty. However, a large number of private enterprises in emerging industries, such as Ningde Times, Lianying Medical, etc., with the help of financing channels such as Emerging Industry Investment Fund, seized the favorable opportunity when China was vigorously developing strategic emerging industries and achieved rapid growth and development [20]. But the more serious situation is that when economic policy uncertainty increases, it becomes more difficult for banks to assess the risks and solvency of enterprises and supervise enterprises' investment projects. To avoid adverse selection, the number of loans to enterprises will be reduced, thus increasing the cost of debt financing for firms. The uncertainty of economic policy increases the external financing cost of enterprises [21].

Tian, Chen, and Gu [22] think that the point of view of enterprise management, the economic policy uncertainty will increase the difficulty of the economic policy judgments about the future enterprise management situation. Secondly, from the point of view of firm management, the uncertainty economic policy will increase the difficulty of the firm management state economic policy judgments about the future, affect their expectations of economic policy. Since enterprise management is risk-averse, the increase of economic policy uncertainty will weaken the willingness of enterprises to invest, thus reducing the market risk and legal risk faced by enterprises in the future. Rao, Yue,

and Jiang find that economic policy uncertainty affects firms' investment and influences their investment efficiency. They use various methods to measure investment efficiency and find that the increase of economic policy uncertainty will improve the investment efficiency of Chinese firms [23]. Thus, the economic policy uncertainty has a great impact on the investment and financing of firms. Even a relatively negative impact and continuous adjustment and correction are needed to promote the development efficiency of firms.

3. EARNINGS MANAGEMENT

3.1. *The relationship between independent director and earnings management*

There exists a highly connected and interdependent network between firms. Also, the results show that the companies are related in their entirety, and there is a high degree of interaction [24].

Through multiple regression analysis, it can be concluded that independent directors have an inhibitory effect on earnings management of management manipulation R & D activities. Too many part-time companies of independent directors will weaken the role of supervision. The younger the independent directors are, the stronger the role of supervision is.

Therefore, enterprises should pay enough attention to the role of independent directors in corporate governance, appropriately increase the proportion of independent directors, and consider the number of part-time and age factors when selecting and hiring independent directors. It is conducive to improving the level of corporate governance [25].

From the perspective of supervision, further empirical research finds that increasing the size of independent directors and improving the salary level of independent directors will weaken the inhibitory effect of EVA assessment on earnings management. Still, independent directors with a local financial background can promote the inhibitory effect of EVA assessment on earnings management [26].

In terms of independent directors with technical backgrounds, independent directors with technical backgrounds can control R & D expenses to restrain the degree of earnings management. The characteristics of high risk, strong specialization, and a high degree of information asymmetry in R & D activities make managers more inclined to take Reducing R & D expenses as an important means of real earnings management [27].

The appointment of non-executive directors by major shareholders to listed companies can effectively supervise the management and reduce agency costs,

which reduces the level of over investment and earnings management of listed companies. Although the executive compensation incentive scheme stimulates the executives to a certain extent, it also induces the motivation of the executives to manipulate earnings to obtain excess compensation [28]. Compared with non-executive directors, the executive director of the controlling shareholder has a stronger information advantage and can directly restrain the earnings management behavior of the managers [29].

3.2. *Corporate governance and earnings management*

The higher the shareholding ratio of institutional investors is, the better the corporate governance is. The level of corporate governance is negatively correlated with the degree of earnings management. Institutional investors can effectively supervise the earnings management behavior of management. In the three quarters before the announcement of the equity incentive plan, managers conducted downward earnings management by manipulating "discretionary accruals", and there was a reversal of earnings after the announcement [30].

To a certain extent, the degree of investor protection represents the external legal level of listed companies, and strict external legal constraints are conducive to restraining accrual and real earnings management behavior [31].

3.3. *Sex and earnings management*

Wondering whether non-executive female directors go beyond the neoclassical measurement and recognition-based accounting issues and pay more attention to the classification of core expenses within the income statement, results reveal a significant positive relationship between non-executive female directors and classification shifting [32].

To examine how women on boards influence bank earnings management, an inverted U-shaped relationship between women on boards and bank earnings management is used. Specifically, when there exists only a marginal number of women directors, banks are more likely to manipulate earnings. Whereas, when the number of women directors reaches three or more, bank earnings management declines [33].

Conducted in the French context where firms are pressured since 2010 to appoint more women on boards, through testing the panel regressions, women on boards are effective in their monitoring role. Indeed, the findings show a significant negative effect of board women presence on earnings management practices level. However, there is no empirical evidence that

board gender diversity affects the earnings management strategy [34].

4. THE RELATIONSHIP BETWEEN ECONOMIC POLICY UNCERTAINTY AND EARNINGS MANAGERMENTS

Economic policy uncertainty impacts the whole economic market, and the firms are directly participating in the market. Thus firms naturally are afraid to be affected by the change of the policies [35]. At this time, the firm responds to the risk of policy uncertainty through various financial decision-making behaviors, and surplus management is one of the financial decision-making behaviors that the firm likes to use. The relationship between economic policy uncertainty and earnings management has both positive and negative directions. Scholars have always been controversy about the relationship between these two. Results are different when the premises are different, which means policy uncertainty can result from different reasons. And then a part of results lead to stronger usage of earnings management, and other parts may limit firm's management.

Some people support the theory that the existence of economic policy uncertainty makes firms use earnings management more frequently. The uncertainty of government economic policy leads to the instability of a firm's cash flow. The possibility exists that when the new policy occurs, the stock price is easy to fall. And if the uncertainty is huge and brought relatively different market influences, a short-term economic recession may occur, which causes a firm's stock price to fall more sharply [6]. Compared with other market participants, the firm's managers have more specific and correct predictions about the impact of external policy changes on the firm, which means that information asymmetry exists between the two parts [7]. So Cui, Yao, Fang, et al. [8] suggest that firms need to use more accounting conservatism to solve the problems caused by policy uncertainty. [9] Chen and Chen found that the instability of economic policies, like the province government leader's change, makes companies with high-profit accounting information subject to social suspicion and unfavorable behavior of the government. At this time, the firm may smooth the profit data in the report to prevent itself from falling into such a terrible situation. In addition, if economic policy uncertainty causes the firm to face greater government-related economic transfers such as increases of tax or tariff, the firm chooses to use accounting procedures to employ earnings management to reduce the cost of increased government regulation. Like those in China, under China's economic policy and political system, economic policy uncertainty growth drives an increase in earnings management behavior, especially companies that have less monitoring outside [8]. Under these circumstances,

people also need to realize that the positive relationship of economic policy uncertainty on corporate earnings management is also related to the intensity of uncertainty, which is then influenced by the quality of government and the dependence between enterprises and government [9]. The sensitivity of enterprises to the economic policy uncertainty also depends on the nature of the firm and the share of shares held by management. Like those in China, non-state-owned enterprises are more sensitive to changes in economic policies and begin to implement earnings management methods faster. When the firm's managers hold fewer shares, the firm is more sensitive to economic policy changes [36].

Other scholars believe in the theory that shows the negative relationship between economic policy uncertainty and earnings management. When the uncertainty of government policy grows stronger, the government's regulations on firms improve. At this time, the government asks the firm to submit more financial statements and other reporting. Thus the firm's reporting management suffers greater risk. The result is that the government's supervision reduces the firm's strength for such management. [10] Kim and Ho believe that economic policy uncertainty restricts the firm's real earnings management because economic activity is reduced as a result. And according to the statistical analysis of the actual US firm samples, the negative relationship between the uncertainty of economic policy and the firm's earnings management should depend on the stage the firm stands on. That is to say when the policy uncertainty appears or becomes stronger, the firm which is in the introduction, growth, and recession stages reduce earnings management [11]. And in Korea, when the government is updated, the last government is a series of inspections to discharge the government's economic policy, and the firm reduces the surplus management due to fear of political scandals such as bribery or corruption allegations [10].

5. CONCLUSION

In general, the conception of economic policy uncertainty is the current government economic policy and cannot predict, leading to many relevant problems. For example, mentioned the household's consumption and inflation, both supplement each other, actually short-term, medium-term or long-term overall have negative effects so that influence the enthusiasm of consumer even depress consumption ability. On the other hand, economic policy uncertainty also negatively impacts the investment and financing of enterprises. Firms can seize the national dividend or have the opportunity to rise rapidly. However, in most periods, enterprises are restricted by the external environment and internal conditions. This paper provides three interpretations on the definition of earnings management and discusses the relationship between it

and independent directors, corporate governance, and sex. It turns out that independent directors with technical backgrounds are more likely to enhance earnings management. Also, investor protection indicates how well corporate governance contributes to earnings management. Finally, the female seems to perform relatively unsatisfying on boards to manage earnings, but there's still a mystery on how gender diversity affects earnings management.

In this paper, we investigate the relationship between economic policy uncertainty and earnings management. The relationship between these two includes positive aspects and negative aspects. There are three reasons to justify the positive relationship. Firstly, firm insiders and other market participants have a problem of information asymmetry in the perception of the economic policy uncertainty impact on the company stock prices. Therefore, the firm needs to use earnings management to make adjustments to stabilize the confidence of other market participants in this firm. Second, to prevent companies with high-profit reports from receiving excessive attention from the new government, firms need to increase the use of earnings management to adjust report data in the reporting, thereby reducing review risks. Third, economic policy uncertainty may increase the amount of tax that the company needs to pay, enabling managers to carry out earnings management from the perspective of the company's interests.

In addition, the negative relationship between economic policy uncertainty and earnings management also exists. The new government's appointment prefers to increase the government's scrutiny of the firm because it is necessary to determine and investigate whether the previous government has corruption. Under the supervision of the government for some time, the company reduces the behavior of earnings management. Besides, firms in the introduction, growth, and decline phase reduce earnings management when economic policy uncertainty increases.

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